EXHIBIT 30

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May 13, 2004

Lawrence Grissom
Retirement Administrator
San Diego City Employees' Retirement System
401 B Street, Suite 400
San Diego, California 92101

RE: James F. Gleason, etc. v. San Diego City Employees' Retirement
San Diego Superior Court Consolidated Case No. GIC 803779
Our File No. 7835.56570

Dear Mr. Grissom:

This law firm represents San Diego City Employees' Retirement System ("SDCERS") in three consolidated actions currently pending before Judge Patricia Y. Cowett, of the Superior Court of the State of California, County of San Diego, under the lead caption, *James F. Gleason, et al., Plaintiffs v. San Diego City Employees' Retirement System, et al., Defendants*, San Diego Superior Court Case No. GIC803779 ("the *Gleason* litigation"). Pursuant to a vote of SDCERS' Board of Trustees (the "Board") on March 11, 2004, SDCERS conditionally agreed to settle the *Gleason* litigation according to terms stated in the February 19, 2004, document entitled "Settlement Terms In Concept That City Manager Will Recommend To City Council For Approval And Which SDCERS' Counsel And Litigation Representative Will Recommend To The SDCERS Board For Approval And Which Are Agreeable To Plaintiffs And Their Counsel" ("the Term Sheet"). On March 9, 2004, the City Council voted to approve settlement of the *Gleason* litigation pursuant to the provisions of the "Term Sheet."

Paragraph 8 of the Term Sheet states, in pertinent part: "SDCERS' approval is subject to review and approval by independent fiduciary counsel." SDCERS has selected Jan Webster, Esq., and Dan Riesenberg, Esq., of Pillsbury Winthrop, LLP, to serve as the independent fiduciary counsel required by the Term Sheet ("Fiduciary Counsel"). As part of its analysis, Fiduciary Counsel has requested that this firm, in its capacity as litigation counsel in the *Gleason* litigation, provide an analysis of the risks and benefits of litigating this action to a final enforceable judgment, rather than resolving it through settlement. This letter is presented to you on behalf of the Board in satisfaction of that requirement.

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SUMMARY OF OPINION

1. It is reasonably probable that Plaintiffs' Motion for Summary Adjudication of the issue of whether Manager's Proposals I and II violate City Charter, Article IX, section 143, would be granted. An enforceable judgment allowing the Board to set new amortization rates would be delayed until mid 2006 to early 2007.

2. A bare probability exists that a court would conclude the Board breached its fiduciary duty by approving Manager's Proposal II. However, the nature of Plaintiffs' damage claim based thereon makes it unlikely that substantial monetary damages would be awarded on the basis of this claim.

3. It is probable the Court would conclude the Board's vote to adopt Manager's Proposal II violated Government Code section 1090, thereby invalidating the vote.

4. It is possible that a court order invalidating Manager's Proposals I and II on a going forward basis could result in a greater net monetary recovery for SDCERS than would be obtained under the settlement. However, it is probable that an enforceable judgment would be delayed by appeals until approximately 2007. Furthermore, any right to increased payments in the immediately ensuing years would not be protected by any form of collateral to secure such payments. The Board would incur approximately $300,000 to $500,000 in additional attorney's fees and costs to obtain a final judgment under this scenario.

5. It is unlikely that a court would enter an order invalidating Manager's Proposal II, but permitting selective enforcement of Manager's Proposal I in such a manner that resulted in a superior monetary recovery than would be obtained under the settlement.

6. It is probable that the Court would enter an order permitting some amount of restitution for past underfunding by the City. However, we cannot predict with any reasonable certainty what amount might be awarded. Furthermore, an enforceable judgment under this claim would likely be delayed by appeal for a period of between 18 months and three years. SDCERS would incur approximately $300,000 to $500,000 in additional attorney's fees and costs during this time.

7. The settlement achieves substantially all of the most likely results of a litigated resolution of this matter, and does so far sooner than would be accomplished

under a litigated resolution, at a lower cost to SDCERS. It substantially increases the amount of money contributed to SDCERS in the upcoming fiscal years, it returns SDCERS to an actuarially-based contribution method, and it allows the Board to implement the most recent changes in actuarial assumptions significantly sooner than would otherwise be possible.

BACKGROUND

Our analysis is based on the following sources of information. This firm has been counsel of record for SDCERS in the *Gleason* litigation since its inception, a period of approximately 17 months. During that time, we have reviewed approximately 100 bankers boxes of documents from sources including: SDCERS, Gabriel, Roeder & Smith ("GRS"), Hanson Bridgett, the City, and Morrison & Forester, out of which we have produced approximately 10,000 pages of documentation. We have conducted approximately 100 hours of interviews with SDCERS Staff, Trustees, Actuaries, Fiduciary Counsel, and independent third party witnesses. We have participated in the depositions of the following individuals: Lawrence Grissom, Fred Pierce, Ron Saathoff, Terri Webster, Cathy Lexin, Mary Vattimo, John Torres, Robert Blum and Constance Hiatt. We have reviewed transcriptions of SDCERS Board meetings conducted in June, July and November 2002. We have conducted legal research relevant to the claims and defenses implicated by the causes of action stated in the *Gleason* litigation.

Reference to specific items of evidence in the following sections is not, and should not be construed as, a comprehensive or exclusive list of evidence relevant to the particular issue addressed, but is instead intended to provide an example of the evidence which might bear on the particular issue, should this matter proceed to trial.

SUMMARY AND ANALYSIS OF THE FACTS

In the event this matter had proceeded to trial, and thereafter appeal, the following facts would likely have been proven by a preponderance of the evidence. Thus the following facts constitute the record upon which the issues of law presented in the *Gleason* litigation would have been decided.

A. The '96 Agreement ("Manager's Proposal I").

In or about June 1996, the City Manager proposed an "Employer Contribution Rate Stabilization Plan" ("Manager's Proposal I"). The principal feature of Manager's Proposal I was that contribution rates would be set based on an agreed rate between the City and SDCERS independent of the contribution rate derived from calculations by SDCERS' actuary, Rick Roeder of GRS. Under Manager's Proposal I, contribution

rates would be calculated on the basis of the projected unit credit (PUC) actuarial method, with specified contribution rates in the ensuing two fiscal years of 7.08% and 7.33%. Thereafter, the contribution rate would increase by 0.50% each year until the contribution rate reached the rate calculated on the basis of the entry age normal (EAN) actuarial method. Significantly, the City Manager's proposal also specified:

> "In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation...the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City-paid rate will be the amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation."

The City Manager's stated reason for presenting the "Employer's Contribution Rate Stabilization Plan" was the unanticipated fluctuation in the Employer's Contribution Rate under the projected unit credit actuarial method adopted in 1992.

Several witnesses have testified that Manager's Proposal I was presented to the Board for approval contemporaneously with the City's negotiation of new labor contracts with its unions. These negotiations included promised retirement benefit enhancements for union members. Pursuant to City Charter, Article IX, [1] Section 144, a majority of the Board was comprised of individuals whose pensions would have been affected by the outcome of the City-Union labor negotiations.

1. First Opinion Issued by Fiduciary Counsel.

The question of whether the Board would be discharging its fiduciary duties in adopting Manager's Proposal I was submitted to fiduciary counsel for an opinion. Counsel noted that nothing in the proposal "changes the Board's discretion to adjust the actuarial assumptions on which the System is based as needed in order to insure the long term funding integrity of the System." This comment, however, failed to take into account that Manager's Proposal I required the contribution rates be set independent of actuarial calculations, such that changes in actuarial assumptions would have no effect on contribution rates over the lifetime of the agreement. Nonetheless, counsel concluded:

[1] Unless otherwise specified, all section references to the City Charter are to Article IX thereof.

> "Provided the City-paid rate in the [Plan] is not less than an amount substantially equal to that required of employees for normal retirement allowances as certified by the actuary, the Board will be acting within the discretion granted to the Board to administer the System and discharging its fiduciary duties set forth in Article XVI, Sec. 17 of the California Constitution."

Counsel's statement derived from (without referencing) City Charter section 143, the determinative provision in the *Gleason* litigation. Counsel's allusion to section 143 drew only on one phrase ("The City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances..."), but failed to reference, let alone analyze, the subsequent phrase ("...as certified by the actuary...") which became the cornerstone of the Plaintiff's case in the *Gleason* litigation. Moreover, counsel's letter provided no analysis of the final sentence of section 143, which again references the interdependent relationship between SDCERS' Board and Actuary in all matters relating to the retirement system's operation.

2. Additional Opinions Issued by Fiduciary Counsel.

In response to questions from members of the Board, fiduciary counsel issued a second opinion addressing SDCERS' duties under *Claypool v. Wilson* (1992) 4 Cal.App.4th 646, and related cases. The Board wanted to ensure that the modification of vested pension rights which would result from adoption of Manager's Proposal I were "offset" by an "increase in benefits and other advantages granted to the beneficiaries" of SDCERS. In an apparent reference to promised retirement benefit enhancements at issue in the concurrent collective bargaining process, counsel noted that "other aspects of the City Manager's proposal" conferred increased benefits on the SDCERS members. This, combined with the conclusion that "stabilization of employer contribution rates is directly related to the functioning and integrity of the system," led counsel to conclude the Board was acting in a manner consistent with its duties under *Claypool*.

In its second opinion letter, fiduciary counsel also addressed two additional issues raised by Board members, that remain relevant to the *Gleason* litigation. First, counsel noted the Board is held to the standard of professional bankers and bank investment advisors, and therefore has "a duty to determine the financial viability of the City before it approves contribution payments at a level less than that recommended by the actuary." Failure to carry out this duty, counsel noted, would be a breach of fiduciary duty. After reviewing the available information, counsel concluded a process existed

through which the Board could satisfy itself of the City's financial viability. Testimony elicited by Plaintiff's counsel in the *Gleason* litigation from several witnesses shows such an investigation was never undertaken, let alone completed to the satisfaction of fiduciary counsel or the Board.

Next, counsel noted that, because "the Board has no authority to determine benefits or to make benefit changes," it "should not engage in negotiations for benefit changes or increases." Nonetheless, certain Board members inquired as to whether the "real conflict" presented by Board members voting on proposals which would confer financial benefits on themselves would prevent those Board members from voting on the proposal. Fiduciary counsel noted that the City Manager's proposal made adoption of increased benefits in the concurrent labor negotiations contingent on approval of reduction of the City's funding obligation. However, counsel noted the drafters of the City Charter (through which SDCERS was established) "were aware of possible conflicts of interest inherent in the appointment of those [financially interested] members of the Board." Under these circumstances, counsel opined, the "bare potential for a conflict of interest does not categorically bar a fiduciary from functioning as a trustee." Counsel did not, however, notify the Board of the existence of Government Code section 1090,[2] nor provide any analysis of its effect on the Board's ability to deliberate or vote on the issue before it. Notwithstanding this omission, counsel concluded:

> "[I]t is our opinion that those Board members who voted in favor of the proposal solely in the interest of, and for the exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system, did not have a conflict of interest sufficient to bar him or her from functioning as a trustee."

According to Mr. Roeder, the performance of relevant financial markets during the 1996 through 2000 time frame caused the funded ratio to far exceed the "trigger" established by adoption of the '96 Agreement. Mr. Roeder noted it was generally accepted that the funded ratio trigger was 82.3%, but because the funded ratio never

[2] Government Code section 1090 states: "Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members." This section applies to persons in the position of SDCERS Board members. (Govt. Code § 82048.)

approached that level, certain potential ambiguities in Manager's Proposal I were never resolved.

B. The 2002 City Manager's Proposal ("Manager's Proposal II").

On June 10, 2002, the City Manager, on behalf of the Mayor and City Council, requested that SDCERS approve an amendment to Manager's Proposal I as follows:

> "The floor for the actuarial funded ratio of SDCERS will be established at 75%.
>
> "The City will pay contributions at the 'agreed to' rates for FY96 through FY07 as contained in the Manager's Proposal. If the actuarial funded ratio falls below the floor in any year, the City will increase its contribution rate on July 1 of the following year by an amount equal to one-fifth of the amount necessary to reach the full actuarial rate. The City will pay this increased amount for each of the subsequent four years in order to achieve the full actuarial rate over a five year period."

The City Manager identified as the basis for the proposed amendment several "unprecedented events" during the preceding two years, including the events of September 11th, "the collapse of the dot com industry," the "overall fall in the investment market," the "specific loss of revenues in the San Diego economy, and the anticipated raid on local revenues by the State of California."

Contemporaneous documents, as well as testimony of multiple witnesses in the *Gleason* litigation, prove that -- as with Manager's Proposal I -- Manager's Proposal II was linked to the City's collective bargaining with its unions over new labor contracts. The evidence is clear that the City promised its unions enhanced retirement benefits, contingent on the Board's adoption of Manager's Proposal II. The evidence is likewise clear that the linkage between enhanced retirement benefits for City employees, and adoption of a new "contribution agreement" was repeatedly emphasized in communications between City labor negotiators and SDCERS Board members.

1. Opinion Issued by Fiduciary Counsel.

SDCERS requested an opinion from its current fiduciary counsel, Robert Blum, Esq., as to whether adoption of Manager's Proposal II was consistent with the Board's fiduciary duties. In an unsigned draft opinion letter dated June 12, 2002, Mr. Blum summarized the circumstances leading to the City Manager's request for adoption of Manager's Proposal II, including: the total of contributions by the City and members to

SDCERS was insufficient to cover the normal cost and interest on past service cost computed at the actuarial funding rate; from July 1996 to June 2002, the difference between actual City contributions and actuarially calculated contributions totaled approximately $90 million; and, "it is estimated that as of June 30, 2002, SDCERS funding ratio will be close to 82.3%." The last factor listed by Mr. Blum was clearly the most critical from the City Manager's perspective, insofar as "hitting the funded ratio trigger" would, according to one interpretation of Manager's Proposal I, (supported by at least a plurality of the Board,) require an immediate additional cash contribution of between $25 million and $75 million.

Mr. Blum noted that since Manager's Proposal I was executed, the law governing employees' interests in their retirement system had been "substantially strengthened," thus limiting the ability of employers to alter contribution obligations in a manner that affected vested benefits. Moreover, Mr. Blum noted that the ability to "mitigate" funding reductions through provision of "comparable new benefits" was "not governing with respect to the Board's responsibility to act prudently. If it were governing then each time that employer persuaded a Board to reduce contributions, it could avoid challenges by increasing benefits. That would not pass elementary actuarial requirements."[3]

Significantly, Mr. Blum noted that one of the questions left unanswered by the City Manager's proposal was the means by which the City would fund its contribution obligation under the proposed modification to Manager's Proposal I. Again, testimonial evidence elicited in the *Gleason* litigation shows the issue of "investigating the City's ability to pay" was not done, despite the warnings of fiduciary counsel in both 1996 and 2002.

After more than a dozen pages of analysis, Mr. Blum's unsigned draft opinion concluded:

> "Under the facts as we understand them, and for the reasons discussed above, *it is our opinion that there is a material risk that if the Board were to agree to the proposed amendment to the Manager's Proposal in its current form, and if this decision were challenged in court, a court would hold that the decision was not a proper exercise of the Board's fiduciary responsibilities based upon the facts before the*

[3] Mr. Blum's opinion on this issue appears to directly contradict at least one basis upon which prior fiduciary counsel opined that adoption of Manager's Proposal I was a proper exercise of the Board's fiduciary duties.

Board and the actuaries [sic] opinion to the contrary. A court would look at whether the Board had substantial evidence to support the propriety of its actions and there is a material risk that a court would find such evidence lacking." (Emphasis added.)

2. Mr. Roeder's Presentation Regarding Manager's Proposal II.

On June 12, 2002, SDCERS' actuary, Mr. Roeder, made a presentation to the Board that was critical of Manager's Proposal II. Among the most important points Mr. Roeder made were the fundamental inconsistency, from SDCERS' point of view, between the "enhanced benefits" aspect of the proposal, and the "contribution relief" aspect of the proposal. Mr. Roeder also laid out the following facts, which he concluded were relevant to the Board's decision:

(a) SDCERS' role should be largely independent of the setting of existing or potential benefit levels;[4]

(b) Existing benefits for City employees were not below average compared to other state and national public systems;

(c) SDCERS is one of the few retirement systems to use PUC funding, and on that basis has one of the lowest funded ratios in California; moreover the existing funded ratio is at its lowest point since the 1980's; and

(d). The gap between the computed PUC actuarial rate and the City contribution rate has been increasing since implementation of the '96 proposal.

Mr. Roeder also noted several mitigating factors. Foremost among them, it appears, was that SDCERS would "be able to make benefit payments over the next 10-15 years regardless of the decision made to grant potential additional funding relief."

In his presentation to the Board, Mr. Roeder stated, "What the City proposes is *outside the norm for generally accepted actuarial funded policies* (emphasis added)," a

[4] Despite having been prominently discussed in the '96 fiduciary counsel opinion letter, this appears to have been the only instance in which SDCERS' unwilling involvement in labor negotiations was mentioned in the process by which Manager's Proposal II was analyzed.

circumstance which he felt "place[d] an added burden in our view as trustees to exercise our fiduciary responsibility appropriately." Mr. Roeder stated that if the Board was "willing to accept this version of the manager's proposal, I want everyone here to be totally cognizant of the fact that the way I understand the current version is it will [be] possible for the funded ratio to go below 75 percent and possibly significantly below." Finally, Mr. Roeder made clear he was more comfortable with Manager's Proposal I because of the "hard floor" of 82.3%.[5]

Transcripts of the June 2002 Board meeting document the differences of opinion that existed among both Board members and Staff regarding the proper interpretation of Manager's Proposal I's "catch-up" provisions. At issue was whether the entire underfunded amount came due in the immediately following year, or whether some longer term applied. Mr. Blum, along with Mr. Roeder, noted that under reasonably anticipated circumstances, if the funded ratio fell below 82.3%, as it was expected to do, the catch-up provision would require the City to contribute approximately $75 million in FY03.

3. The City Manager's Response.

On June 18, 2002, the City Manager issued a memorandum to SDCERS purporting to respond to concerns raised by Mr. Blum's June 12 draft correspondence. There appears to have been no attempt to respond to Mr. Roeder's concerns as expressed in his presentation. Significantly, despite Mr. Roeder's concerns over "dropping the hard floor" from 82.3% to 75%, the City Manager's memorandum left that provision unchanged. Additionally, the City Manager responded to Mr. Blum's concern regarding "funding status and anticipated earnings" over the later stages of Manager's Proposal II by stating:

> "This is a very broad question which includes the work initiated by the Mayor's Blue Ribbon Committee on City Finances, the SDCERS

[5] From the perspective of a litigation risk analysis, perhaps the most significant variable in the *Gleason* litigation is the fact that SDCERS' actuary, Mr. Roeder, was not deposed prior to execution of the Term Sheet. It is, of course, a certainty that should this matter proceed to litigation, Mr. Roeder would both be deposed, and likely become the central witness in the Plaintiff's case. Based on extensive review of Mr. Roeder's files, as well as many hours of formal and informal interviews, it is our opinion that Mr. Roeder's testimony would ultimately support a trier of fact in concluding that Manager's Proposal II was not an actuarially sound method for making contributions to a retirement system.

> subcommittee on surplus earnings and contingent benefits, and the need to develop a long term funding policy. It is recommended that a plan and schedule be developed to complete this policy work."

The only substantive modification to the original proposal was an increase in the City's "agreed contribution rate" from 0.50% to 1.00% effective July 1, 2004. This proposal is, at the very least, puzzling in light of the City Manager's non-response to Mr. Blum's questions concerning financing,[6] and the City's purported justification for seeking contribution reduction in the first place, i.e., that it expected the State to "raid" City revenue sources beginning in 2004, thus worsening its short-term financial outlook.

On July 3, 2002, the City Manager provided SDCERS with another memorandum "clarifying" the terms of the proposal, as well as responding to concerns by Board members. Significantly, the City Manager's "clarification" stated that the City had agreed to increased benefits for its employees during labor negotiations, "contingent" upon SDCERS accepting a reduction of its contribution obligation; yet in response to a Board member's question as to why SDCERS was placed in the middle of labor negotiations, the City Manager denied such a thing had occurred. Also significant was the City Manager's response to the Board's question of "why we should assume the City will find it easier to pay much higher pension costs in the future:"

"It will not be easier nor desirous, just necessary."

No further information was provided as to how the City would meet the contribution obligation outlined in its proposal.

4. July 11, 2002 Board Meeting.

On July 11, 2002, another Board meeting was held at which Mr. Blum provided an analysis of the effect of the "changes" the City offered in an effort to gain acceptance

[6] Discovery conducted during the *Gleason* litigation has produced only a single memorandum prepared by the City, purportedly in response to Mr. Blum's statements regarding investigation of the City's financial condition for purposes of determining its ability to meet the anticipated financial burdens of Manager's Proposal II. However, the City memorandum addressed only its superior credit rating, and not its ability to draw on existing or anticipated sources of revenue to meet its cash contribution obligations. The evidentiary record is otherwise silent as to any investigation by SDCERS of the City's ability to make annual contributions.

of Manager's Proposal II. At that meeting Mr. Roeder made clear that the 82.3% trigger would be hit in June 2003. Thereafter, the Board devoted its discussion to the difference in funding obligations between competing interpretations of Manager's Proposals I and II. After lengthy and detailed discussions, Mr. Saathoff proposed that the 75% trigger in Manager's Proposal II be replaced with the existing 82.3% trigger. Additionally, the modified proposal would incorporate the provision in the original Manager's Proposal II that gave the City five years after the trigger was hit to "reach the full actuarial rate."

In the final minutes of what was a very long meeting, before a vote was taken, the Board asked both Mr. Roeder and Mr. Blum whether adopting the proposal was "a prudent exercise of our responsibility." Mr. Roeder appears to have responded that the final version of the proposal fell somewhere between Manager's Proposal I and the original formulation of Manager's Proposal II. Mr. Blum stated it was difficult to give "an on-the-fly opinion," before concluding:

> "I can tell you it's a lot easier to give an opinion that you would not be at material risk. Exactly how far that opinion can go, exactly what the words are, that's a little difficult to tell you because we don't have the facts."

A vote was taken immediately thereafter, in which the modified Manager's Proposal II passed 8 to 2, with one abstention.

5. Contract Negotiations.

From July through November 2002, Mr. Blum and his partner, Constance Hiatt, prepared multiple drafts of a fiduciary opinion letter on the propriety of the Board adopting Manager's Proposal II. At the same time, Mr. Blum acted as SDCERS' lead negotiator with the City regarding the contents of the contribution agreement that would ultimately become the final version of Manager's Proposal II. As a result, Mr. Blum became the primary witness to the process by which Manager's Proposal II was created, endorsed and adopted.

Unfortunately, both Mr. Blum and Ms. Hiatt were ineffective witnesses when deposed in the *Gleason* litigation. Mr. Blum and Ms. Hiatt both testified that they "do not recall" researching, analyzing, or otherwise investigating, whether Manager's Proposal II would violate Charter section 143; nor was either lawyer able to recall having considered whether the Board's adoption of Manager's Proposal II would violate anti-financial interest laws such as Government Code sections 1090 et seq., or 87100 et seq. In any event, the opinion letter ultimately issued by Mr. Blum made no mention

whatsoever of the impact of sections 143, 1090 or 87100 on the Board's decision. Moreover, Mr. Blum was unable to explain the omission from his final opinion letter of more than two dozen facts regarding Manager's Proposal II which had been set forth in support of the negative conclusion stated in his June 2002 "draft opinion letter."

On November 7, 2002, Mr. Roeder provided certain written "statements in regard to the amendment to the Manager's Proposal."[7] From the perspective of the *Gleason* litigation, the most significant statements Mr. Roeder made were:

> "(c) It is likely that the 82.3% trigger point will be hit by June 30, 2003,...
>
> "(d) The higher the City's contribution levels, the better the funding status of SDCERS...
>
> "...
>
> "(g) From a pure actuarial viewpoint, it would be best to hold the City to the existing Manager's Proposal and the 82.3% trigger (particularly if one of the two 'high contribution rate' interpretations of the effects of hitting the trigger were to prevail)."

Mr. Roeder's letter did not include any statement to the effect that adoption of the modified Manager's Proposal II conformed to generally accepted actuarial principles, or that it was a prudent exercise of the Board's fiduciary responsibility.

On November 15, 2002, Mr. Blum reported to the Board on the results of his negotiation with City representatives regarding the provisions of the Memorandum of Understanding setting forth the final terms of Manager's Proposal II. Notwithstanding unresolved issues relating to linkage of benefit enhancements to contribution reduction, as well as investigation of the City's ability to make the projected contributions called for under Manager's Proposal II, the Board's discussion centered on assumptions underlying the exemplar calculations in the Memorandum of Understanding.

Significantly, the first mention of "indemnification" of the Board by the City for unspecified consequences of adopting Manager's Proposal II appears in the record of

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[7] A version of this letter dated November 5 also exists. The differences between the two versions appear immaterial, but have not been fully explored during discovery in the *Gleason* litigation.

the November 15 meeting. Transcripts of the hearing indicate the discussion became extremely contentious and acrimonious. It appears from both the minutes and transcript that the Board concluded Mr. Blum essentially supported adoption of the MOU because the Board had engaged in prolonged and difficult evaluation of the proposal before adopting it. The record does not include any discussion of the propriety of the Board's action in light of the relevant language from Charter section 143 or on the issue of disqualifying financial interests under Government Code sections 1090 or 87100 caused by the link between benefit enhancement and contribution reduction.

Furthermore, at least one Board member acknowledged that Mr. Roeder was "hesitant" to endorse the proposal. Mr. Roeder confirmed this interpretation of his feelings, stating that he felt it was "inappropriate" and placed the Board in "a no-win situation" of evaluating a contribution relief proposal that was linked to enhanced benefits for members. Nonetheless, the Board voted to adopt the MOU.

Three days later, on November 18, 2002, -- the same day on which Manager's Proposal II was dated and the City Council resolved to indemnify SDCERS' Board members -- Mr. Blum provided SDCERS with a signed opinion letter, containing an extensive, albeit retrospective, summary and analysis of the Board's decision to approve the modified Manager's Proposal II. Mr. Blum summarized the Board's decision as follows:

> "In essence, the Board decided to trade potential controversy over the meaning of the current Manager's Proposal and the possibility of receiving substantially higher contributions from the City if the 82.3% trigger is met in exchange for materially higher contributions if the trigger is not hit, lower contributions in the first five years if the trigger is hit, a date certain when the full PUC rate is contributed, and agreement on rapid movement to EAN starting at the end of the transition period."

Despite Mr. Roeder's multiple criticisms of Manager's Proposal II, Mr. Blum's only mention of Mr. Roeder's analysis was that the "transition period of moving the City to full PUC rates and then to EAN rates is reasonable based on the terms of the Agreement." Mr. Blum's reference to this limited aspect of Mr. Roeder's overall conclusion is puzzling, since Mr. Roeder explicitly stated that "from a purely actuarial viewpoint," he preferred there be no transition period. Mr. Blum's "final" opinion letter did not explain what caused him to omit numerous negative facts regarding Manager's Proposal II which appeared in his earlier draft opinion letter, nor did it

address section 143 or the Government Code's financial interest statutes. Unfortunately, testimony by Mr. Blum and Ms. Hiatt failed to shed any light on these omissions.

6. Execution of Manager's Proposal I..

On November 18, 2002, SDCERS executed the Agreement adopting Manager's Proposal II. Significantly, the recitals included a statement that SDCERS recognized that "under current fiscal circumstances, undue hardship would be imposed on the City if the Board were to require that the City immediately increase its contributions to the full projected unit credit rate calculated by SDCERS' actuary." Also significant was a previously unmentioned provision allowing the Board to "nullify this Agreement to the extent required by its duties established under the California Constitution and no one shall have any liability for losses or costs on account of such action."[8]

On the same date, SDCERS and the City executed an indemnity agreement, which provided "the City shall defend, indemnify and hold harmless all past, present and future members of the Retirement Board against all expenses, judgments, settlements, liability and other amounts actually and reasonably incurred by them in connection with any claim or lawsuit arising from any act or omission in the scope of the performance of their duties as Board Members under the Charter." Although referenced sporadically throughout the evidentiary record, there is no clear picture of precisely how or why this indemnity agreement was executed contemporaneously with documents relating to Manager's Proposal II. Informal interviews with Staff and City-affiliated witnesses suggest the City has such agreements with each of its related agencies, and that execution of this indemnity agreement was intended only to provide SDCERS the same protection provided to persons serving on other City-related entities.

SUMMARY OF THE LITIGATION

The *Gleason* litigation is comprised of three separate lawsuits, which were consolidated for all purposes on SDCERS' motion ("Complaint"). All claims stated in the three actions will be included in the class settlement, but are summarized separately below.

[8] All witnesses, save Mr. Blum, recall that inclusion of the "nullification provision" was Mr. Blum's idea, and that it was incorporated in the MOU over strong objections from the City. Mr. Blum, however, testified this provision was the Board's idea, and that he simply followed instructions in negotiating for its inclusion in the final agreement.

A. *Gleason et al. v. SDCERS et al. ("Gleason I").*

This is the only one of the three consolidated actions to have been filed as a putative class action. The putative class is alleged to be "all those persons who are no longer employed by the City and are entitled to receive benefits from CERS."[9] The defendants in this action are SDCERS and the City of San Diego.

The gravamen of *Gleason I* is that Manager's Proposals I and II violate both Charter Section 143 and former Municipal Code section 24.0801 by failing to provide for funding of the Retirement System according to the "actuarially calculated rate." The Complaint states a first cause of action for declaratory relief that: (a) "the City has violated the City Charter by failing to fund its retirement plan as required by Article IX, section 143..."[10]; (b) the City has violated San Diego Municipal Code section 24.0801[11] by "failing to fund its retirement plan as required"; and (c) "the City has

[9] Pursuant to the Board's instruction, we have attempted to persuade the other parties to seek a class certification which will also include current City employees, such that approval of the settlement would bind both the class of current members of the retirement system, as well as future members. As of the date of execution of this letter, it appears unlikely the parties will agree to such class certification because of plaintiff counsel's new demand that the parties agree to the amount of fees he will be awarded as a condition to expanding the settlement class.

[10] Charter Section 143 states, in pertinent part: "The City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by the actuary, but shall not be required to contribute in excess of that amount, except in the case of financial liabilities accruing under any new retirement plan or revised retirement plan because of past service of the employees. The mortality, service, experience or other table calculated by the actuary and the valuation determined by him and approved by the board shall be conclusive and final, and any retirement system established under this article shall be based thereon."

[11] Prior to November 18, 2002, San Diego Municipal Code section 24.0801 stated, in pertinent part: "...the City shall contribute to the Retirement fund in respect to members a percentage of earnable compensation as determined by the System's Actuary pursuant to the annual actuarial evaluation required by Section 24.0901..."

As part of the enactment of Manager's Proposal II, this section was amended to state: "The City will contribute to the Retirement Fund, on behalf of Members employed by the City, the amounts agreed to in the governing Memorandum of Understanding between the City and the Board. The Actuary separately determines the City's contributions for General Members, Safety Members and Elected Officers. All

violated San Diego Municipal Code section 24.1111[12] by failing to fund its retirement plan as required."

The Complaint's second cause of action sought a judicial declaration that SDCERS breached its fiduciary duty to its members by allowing "underfunding" of the Retirement System, and whether such underfunding has "unconstitutionally impaired Plaintiffs' vested contractual rights."

Finally, the third cause of action sought in pertinent part:"(a) restitution by the City of all amounts owed to the CERS' [sic] trust fund as a result of the City's past violations of law;[13] (b) an injunction prohibiting the City from unlawful underfunding of the CERS' [sic] trust fund in the future; (c) money damages to the Plaintiff class for retirement benefits which could have and would have been paid but for the defendants' unlawful conduct..."

B. *Gleason v. SDCERS (Gleason II").*

This lawsuit was filed by Plaintiff James Gleason individually, naming only SDCERS as a defendant. The complaint alleges the City proposed to increase pension benefits for active City employees, conditioned upon the Board's adoption of Manager's Proposal II. The Complaint further alleges that certain SDCERS Board members (Cathy Lexin, Ron Saathoff, Terri Webster and Mary Vattimo)[14] had a "financial interest" in the proposed pension benefit enhancements within the meaning of that term as established by Government Code sections 1090 et seq., and 87100 et seq. Finally, the Complaint alleges the foregoing individuals failed to disclose their financial interest in the transaction before voting in favor of Manager's Proposal II.

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deficiencies that occur due to the adoption of any Retirement Ordinances must be amortized over a period of thirty years or less..."

[12] Section 24.1111 stated, in pertinent part: "The City shall contribute to the Retirement Fund a percentage of compensation earnable as determined by the System's Actuary pursuant to the annual actuarial evaluation. The required City contributions shall be determined separately by the Actuary for General Members and for Safety Members."

[13] Notwithstanding Plaintiffs' vaguely worded allegation, subsequent discovery and investigation indicates the amount of this damage claim would have been between $120 million and $130 million.

[14] Although Plaintiff could have named these individuals as defendants in this lawsuit, he did not. Thus, the individual Board members identified in this action have never faced personal liability for violation of either Government Code section 1090 or 87100.

The Complaint states a first cause of action for violation of Government Code section 87100 based on the participation of allegedly financially interested Board members in the vote on Manager's Proposal II. The first cause of action seeks relief in the form of an order "invalidating the decisions of CERS board of administration to approve the City's proposal." Plaintiff seeks precisely the same relief in his second cause of action for violation of Government Code section 1090.

C. *Wiseman v. SDCERS.*

The last of the consolidated actions was filed by Plaintiff Rosado Wiseman, individually, against only SDCERS. Although the gravamen of this action attacked the City's practice of appointing designees to sit on SDCERS' Board in place of the City Auditor and Comptroller and City Manager, the City was not named as a defendant. This action is based on the contention that Charter section 144[15] requires that the City Manager and City Auditor and Comptroller themselves sit on SDCERS' Board as Trustees of the Retirement System. The Complaint seeks an order invalidating SDCERS Board Rule 7.40, which states "[a]n ex officio Board member may designate a member of his or her staff to sit in the ex officio's place on the Board." Although the only purpose Plaintiff alleged for bringing the action was "that the parties can ascertain their respective rights and duties," the Court accepted SDCERS' argument in support of its motion to consolidate the three actions that this Complaint served as yet another vehicle by which the Plaintiff class seeks to invalidate the contribution agreements.[16]

LITIGATION ANALYSIS

The following analysis is organized according to the anticipated chronology of events should the *Gleason* litigation not be resolved by settlement, based on the order of significance to Plaintiff counsel rather than the order in which they appear in the three Complaints.

[15] The relevant excerpt of section 144 states: "The system shall be managed by a Board of Administration which is hereby created, consisting of the City Manager, City Auditor and Comptroller, the City Treasurer,...Members of the Board, other than ex officio, shall serve six years or until their successors are elected..."

[16] We do not provide a detailed analysis of the merits of this action herein, insofar as the settlement will result in dismissal of these claims with prejudice, and we consider the potential effect of these allegations on our litigation analysis *de minimis*, at best.

A. Declaratory Relief Regarding Charter Section 143.

Plaintiffs' claim for declaratory relief regarding Charter section 143 is before the Court in the form of a Motion for Summary Adjudication, a procedure by which the Court may decide a discrete legal issue presented by the Complaint without resolving all disputed issues in a final judgment. Plaintiffs' Motion is made on the grounds that the plain language of Charter section 143 requires the City's employer contribution rates be derived from actuarial calculation, along with Board oversight and approval of the factors and assumptions used to perform such calculations. The effect of a ruling in Plaintiffs' favor on this issue would be to declare Manager's Proposal I and II illegal contracts, thus invalidating the "contribution agreement" method of funding on a going forward basis. SDCERS initially opposed Plaintiffs' Motion due to inclusion of several technical factual defects regarding funding level calculations. However, after Plaintiffs agreed to abandon their faulty arguments, and in an effort to strengthen our negotiating posture with the City, we withdrew SDCERS' opposition and filed a Notice of Non-Opposition to the Motion.

This issue would be the first to be decided by the Court, which would rule in advance of the trial date. Plaintiff counsel has stated that in the event the Court ruled in Plaintiffs' favor he would dismiss the remainder of the litigation to permit an expedited appeal of the trial court's ruling by the City, which would be certain to follow.

In our opinion, a significant possibility exists that the Court would grant Plaintiffs' Motion, and enter a declaratory judgement that Manager's Proposals I and II violate Charter section 143, and are therefore invalid. Our opinion is based on two significant factors.

First, the case law on which this issue would be decided favors Plaintiffs' interpretation of Charter section 143. The California Supreme Court held in 1983 that the City Charter, as amended in 1955, provides for "a retirement system in which contributions of the employees and City to the retirement fund are *computed on the basis of actuarial advice* designed to estimate the funding needed to accrue a guaranteed retirement allowance upon retirement." (*Int'l. Assn. Of Firefighters v. City of San Diego* (1983) 34 Cal.3d 292, 296.) The Supreme Court emphasized "the entire [retirement] system is based on actuarial advice." (*Id.* at 297.)

Courts of Appeal have followed the Supreme Court's characterization of defined benefit retirement plans as actuarially based. In an opinion addressing the issue inherent in the theory purportedly supporting Manager's Proposals I and II – that short term underfunding would be made up in later years – two Courts of Appeal have held, "[w]hen contributions are delayed beyond the date assumed [by the actuary], the plan

falls out of actuarial balance and actuarial soundness is endangered." (*Board of Administration v. Wilson* (1997) 52 Cal.App.4th 1109, 1140; *see also Bianchi v. City of San Diego* (1989) 214 Cal.App.3d 563, 571 ["the retirement system is a contributory system, based on actuarial tables established by the Retirement Board,..."].) Thus, while no case has squarely considered the precise issue presented here, we conclude the foregoing authorities would influence the trial (and appellate) court's reasoning, disposing it favorably to Plaintiffs' interpretation of Charter section 143.

The second significant factor is a factual one. As the Board is aware, both the Securities and Exchange Commission, and the United States Attorney, are investigating whether any laws have been violated, in part as the result of allegedly misleading statements in City bond disclosure statements. One of the City's statements under investigation relates to its funding obligation to the Retirement System: "State legislation requires the City to contribute to CERS at rates determined by actuarial valuations." This statement appeared in bond disclosure documents issued while Manager's Proposals I and II were in effect. The bond disclosure documents were submitted to the Court as supplemental exhibits to Plaintiffs' Motion (after SDCERS filed its Notice of Non-Opposition). It is reasonable to anticipate the Court will interpret this statement as an admission by the City that Charter section 143 *does* require it to make contributions "at rates determined by actuarial valuations." The Court could properly disregard the City's subsequent contradictory statements made in support of its opposition to Plaintiffs' Motion. (*See Thompson v. Williams* (1989) 211 Cal.App.3d 566, 573 ["A party cannot rely on contradictions in his own testimony to create a triable issue of fact."].)

Therefore, based on the legal and factual foundation on which Plaintiffs' Motion is based, we conclude a significant possibility exists that the Court would grant the Motion. The effect of this Motion would be to invalidate, on a going-forward basis, Manager's Proposals I and II, and return the Retirement System to a contribution rate established by actuarial calculation, administered and approved by the Board.

Plaintiff counsel has stated, in the Court's presence, that in the event the Motion is granted he will likely dismiss the remainder of the *Gleason* litigation to allow for an expedited appeal of what he considers the central legal issue in this case. The time line for appeal, even under expedited circumstances, would result in an opinion from the Court of Appeal by approximately July 2005, and possibly as late as January 2006. In the event this action is not settled during the pendency of the appeal, a petition for review to the California Supreme Court would almost certainly be filed, further delaying enforcement of the trial court's ruling until late 2006 or early 2007.

It is extremely difficult to predict how the appellate courts would rule on this issue, particularly given the possibility of new case law being decided during the pendency of the appeal. However, the possibility that the trial court's ruling would be upheld by the court of final review cannot be dismissed as mere speculation. The factors identified as likely to influence the trial court's decision will also influence the appellate court's analysis. It is our opinion those factors work in favor of a conclusion supporting Plaintiffs' interpretation of Section 143. Thus, should Plaintiffs' Motion be granted, the Board would probably have an enforceable judgment allowing it to set contribution rates free of the limitations of Manager's Proposals I and II in calendar year 2006, although the final judgment could be delayed until early 2007.

D. Breach Of Fiduciary Duty.

Although Plaintiff counsel has stated his intention to dismiss the balance of the *Gleason* litigation in the event the Court grants the Motion for Summary Adjudication, we include in our litigation evaluation the following assessment of Plaintiffs' other claims.

Plaintiffs have stated a claim against SDCERS, as an entity (rather than against individual Board members) for breach of fiduciary duty arising from the decision to adopt Manager's Proposal II[17], as modified by the July 2002 vote. Plaintiffs' breach of fiduciary duty claim is styled as a cause of action for declaratory relief. However, Plaintiffs have included a declaratory relief claim regarding the amount of underfunding allegedly caused by the adoption of Manager's Proposal II. Therefore, it is technically possible for "damages" to be awarded based on this claim.

It is important to understand the nature of any such "damages" that might be awarded based on this claim. Plaintiffs' only interest, as members of the Retirement System, is in timely receipt of their individual pension benefits. Under these circumstances, Plaintiffs are only "damaged" by the alleged breach of fiduciary duty if they prove by a preponderance of the evidence that adoption of Manager's Proposal II causes them to receive less than the vested pension benefit to which they are individually entitled. Furthermore, SDCERS' actuary has stated in writing on several occasions – each of

[17] Plaintiffs' causes of action purport to attack the decision to adopt Manager's Proposal I in 1996, as well. However, we consider it at least probable that the Court would rule this aspect of Plaintiffs' claim is barred by the three year statute of limitations governing claims for declaratory relief, and therefore do not analyze this aspect of Plaintiffs' claim in any further detail. (*See Abbott v. City of Los Angeles* (1958) 50 Cal.2d 438, 463-464.)

which would be introduced into evidence at trial – that the Retirement System presently has sufficient funds to pay all benefits currently owed to existing retirees[18] as those benefits come due. Therefore, even in the event Plaintiffs prevailed on their claim for breach of fiduciary duty, we consider it unlikely that they could prove compensible damages as a result thereof.

Although we previously concluded Plaintiffs may prevail on their declaratory relief claim regarding Charter section 143, we do not consider it a certainty that they would therefore necessarily prevail on the associated claim for breach of fiduciary duty. It is important to bear in mind that the declaratory relief claim regarding Charter section 143 presents a narrow and technical issue of law which the Court considers without reference to the process by which the Board adopted Manager's Proposal II. Indeed, that process is irrelevant to the Court's decision making process in ruling on the Charter section 143 claim.

The breach of fiduciary duty claim presents a different question, one for which the Court must examine evidence regarding how Manager's Proposal II was presented, what the Board's response was, and ultimately, whether the Board's decision fell below the standards of reasonableness imposed on a fiduciary. A fiduciary breaches its duty to its beneficiary when it either (a) acts in a manner which fails to place the beneficiary's interests above those of the fiduciary, or (b) acts in a manner which is "unreasonable" under the circumstances. (Cal. Const., Art. XVI, §17, subd. (b); *Hittle v. Santa Barbara County Employees Retirement Assn.* (1985) 39 Cal.3d 374) Under the facts of this case, these tests could be applied interchangeably to the Board's challenged conduct.

Defense of the breach of fiduciary duty claim would center on several significant items of evidence. First, the Board rejected the original proposal in large part because it lowered the "funded ratio trigger" from 82.3%, which its actuary opined was an appropriate safeguard level, to 75%. In light of evidence which existed at the time showing a substantial likelihood that the funded ratio would fall below 82.3% in the

[18] Plaintiff counsel has questioned several witnesses during deposition regarding this assertion. It is clear from plaintiff counsel's questions that the rebuttal to this contention would center on the fact that the calculation assumes essentially all of the Retirement System's assets are used to meet pension obligations owed to existing retirees, with no amount allocated to future retirees. However, in light of the fact the plaintiff class (should this matter be tried) would consist exclusively of existing retirees, it is reasonable to anticipate the Court would exclude plaintiff counsel's argument as irrelevant to the claim asserted by the plaintiff class.

ensuing fiscal year, thus triggering "catch-up" provisions which increased the City's agreed contribution rate, the decision to reject this provision of the City's proposal and demand the 82.3% trigger remain in place constitutes substantial evidence of a proper exercise of the Board's fiduciary responsibility.

The Board also conditioned its approval on specification of the method and rate by which the City's contributions would increase in the event the funded ratio fell below 82.3%, thus adding further certainty to the Retirement System's near-term future. Further, the Board required the annual contributions be increased from the proposed rate of 50 basis points per year, to 100 basis points per year, thus halving the time in which the City would return to "full actuarial rate." Finally, the Board negotiated the inclusion of a "nullification provision," which permitted it to nullify Manager's Proposal II in the future if changed circumstances required it to do so in furtherance of its Constitutional duty to protect the long-term integrity of the Retirement System.

The Board also relied on fiduciary counsel for analysis and opinion. However, the tortured history of the opinion ultimately issued by fiduciary counsel[19] would likely undermine a jury's willingness to conclude the Board properly discharged its fiduciary duty based on this evidence.

While the foregoing list constitutes evidence in defense of the Board's decision, it is important to note that countervailing evidence exists which, in our opinion, is sufficient to meet Plaintiff's burden of proof on their allegation that adoption of Manager's Proposal II violated the Board's fiduciary duty to members of the Retirement System. Foremost on this list is the testimony of several witnesses that, despite having been advised to do so by more than one fiduciary counsel, the Board did not actively investigate the City's ability to make payments as promised. As noted in the factual summary above, the Board was warned on at least one occasion that it is held to the standard of a professional banker, and must investigate both the credit, and ability to

[19] We have detailed earlier in this letter several significant defects in fiduciary counsel's opinion, not the least of which is the almost entirely unexplained inconsistencies between the June 12 "draft" opinion and the November 18 "final" opinion. Almost equally significant is the lack of reference to, discussion, or analysis of, Charter section 143, the central issue in this litigation. Also disturbing is the lack of analysis regarding the means by which the Board might comply with Government Code section 1090, and thus guard against subsequent invalidation of its decision on such grounds. Given these significant questions, it is possible that the Court would conclude it was unreasonable for the Board to rely on fiduciary counsel's opinion without first having conducted further hearing and investigation of these issues.

pay, of someone seeking relief from a financial obligation by deferring all or part of that obligation beyond the existing due date. The Court could well be influenced by evidence from the Board's own fiduciary counsel, combined with testimony of its own witnesses, that it did not discharge this duty, thus jeopardizing the long term stability of the Retirement System by granting relief to an insufficiently creditworthy entity.

Second on the list of unfavorable evidentiary issues is the undisputed linkage between contribution relief and benefit enhancement. While reasonable explanations exist to rebut the inference that individual Board members' votes were influenced by this linkage, it is a truism of litigation that the party with the simplest explanation for an event is most likely to prevail. It is very simple to understand the concept of votes influenced by an expectation of corresponding benefits being bestowed; it is far more complicated to explain why that might not have happened in this particular instance. Evidence of the contribution relief-benefit enhancement linkage (particularly in light of questions surrounding fiduciary counsel's opinion) could dispose a Court (that had already concluded Manager's Proposal II violated Charter section 143) to likewise conclude the Board acted in a manner inconsistent with its fiduciary duties in voting to adopt Manager's Proposal II.

Finally, it is incontrovertible that Manager's Proposal I and II resulted in lower City contributions than would have been made under an actuarially based contribution system. A decision on the issue of breach of fiduciary duty will be made in the context of the facts recited above, but will ultimately come down to an analysis of the undisputed fact of underfunding in light of case law holding that "when contributions are delayed beyond the date assumed [by the actuary], the plan falls out of balance and actuarial soundness is endangered." (*Board of Administration v. Wilson, supra*, 52 Cal.App.4th at 1140.) Although we consider it difficult to predict the outcome of Plaintiffs' breach of fiduciary duty claim, we believe a probability exists that a Court would find in Plaintiffs' favor, although only a bare probability.

E. Section 1090.

Notwithstanding Plaintiffs' professed intent to dismiss their claim for violation of Government Code section 1090[20] should they prevail on the Motion for Summary

[20] The *Gleason* litigation includes companion claims for violation of Government Code sections 1090 and 87100, the latter being known as "The Political Reform Act of 1974." However, case law indicates that remedies for violation of section 87100 are generally used to obtain prospective injunctive and declaratory relief. It should also be noted that the Attorney General has opined on at least one occasion that analysis of a "financial interest" issue under section 87100 is appropriate "only where no conflict of

Adjudication, we consider it important to provide the Board with an analysis of this issue. One significant aspect of Plaintiffs' 1090 claim is that it is pleaded only against SDCERS, and not any individual Board members.[21] Therefore, under the current pleadings the Court could not impose personal liability on any individual Board members, which could otherwise result in disgorgement of any benefits such individuals allegedly obtained as the result of their actions. Instead, the only relief the Court could grant would be to void Manager's Proposal II, as having been adopted in violation of section 1090.

We consider it probable that the Court would find the Board's vote to adopt Manager's Proposal II violated section 1090. A violation of section 1090 will lie only where a public official makes a contract in which he has a "financial interest," whether direct or indirect, in the contract. (*Thompson v. Call* (1985) 38 Cal.3d 633, 645.) An individual has a financial interest in a contract if he or she "might profit from it." (*People v. Gnass* (2002) 101 Cal.App.4th 1271, 1289, fn.6.) An individual participates in the "making" of a contract if they: (1) actually participate in the vote to approve or adopt the contract, (2) are a member of the board that votes on the contract, even if they abstain from the vote, or (3) participate in negotiations regarding the contract, even if they are no longer a board member when the contract is adopted. (*Stigall v. City of Taft* (1962) 58 Cal.2d 565, 569; *Thompson, supra*, 38 Cal.3d at 649.)

A public official shall not be deemed to be interested in a contract if their interest falls within either the "non-interest" or "remote" exceptions to section 1090 established by section 1091.5 and 1091, respectively. "Non-interests" include the interest of a person receiving salary from a government entity, unless the contract directly involves the department of the government entity that employs the person, provided that the interest is disclosed to the board at the time of consideration of the contract, and provided further that the interest is noted in the board's official record. (§ 1091.5 (a)(9).) Likewise, "remote interests" include "salary from a government entity," only if the fact

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interest exists pursuant to [section 1090] but does exist pursuant to [section 87100]." (*In re Russell* (1978) 61 Ops.Cal.Atty.Gen. 243, 253.) Since Plaintiffs' purpose in pleading these claims is invalidation of Manager's Proposal II, we consider the section 1090 claim the far more likely basis for obtaining such an order, and therefore concentrate our analysis on that claim.

[21] Four individual Board members are identified in this claim (Vattimo, Saathoff, Webster and Lexin); however, none are named as defendants, nor are they otherwise parties to the litigation. Instead, they are identified for purposes of establishing the factual predicate for the alleged violation of section 1090.

of the remote interest is disclosed, noted in the board's official records, and the board approves the contract in good faith by a vote sufficient for the purpose without counting the vote of the interested officer. (§ 1091 (a)(13).)

Under the foregoing test, the issue of whether certain Board members were "financially interested"[22] in the vote to approve Manager's Proposal II is the most difficult to analyze, with one exception. Board members Lexin, Vattimo and Webster each were interested in the contract only to the extent of their interest in potentially enhanced pension benefits constitutes "salary" under section 1090.[23] The contract did not "directly involve"[24] the department of the City employing any of the foregoing individuals. Therefore, Manager's Proposal II did not trigger a "financial interest" as to these individuals. However, the record in this case does not include any evidence to show compliance with the "disclosure" and "record" elements of section 1091.5: none of these individuals publicly disclosed their interest in the contract, nor was such disclosure recorded in the Board's official records.[25] Therefore, there would be no

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[22] Under *City of Taft's* extremely broad definition of "participation," there is no question that all potentially interested Board members "participated" in the vote to approve Manager's Proposal II for purposes of a 1090 analysis. Therefore, we do not address this issue in any further detail.

[23] The law on the issue of whether pension benefits fall within the definition of "salary" *as that term is used in section 1090* is unsettled, unclear, and under accepted principles of statutory construction, contradictory. Unlike the Political Reform Act, other relevant Government Code sections, and supporting regulations, section 1090 does *not* include a definition of "salary" which incorporates pension benefits. Furthermore, all other definitions of "salary" which include pension benefits are restricted to Government Code sections *other than* section 1090. However, our analysis does not depend on this issue for its conclusion.

[24] Like the definition of "salary," there is surprisingly little guidance in the law on the definition of "directly involves" as that term is used in the context of section 1090. Some authority exists for the proposition that this term encompasses "contract[s] [which] would specifically affect [a person's] employing unit." (*In Re Aguilar* (1995) 78 Ops.Cal.Atty.Gen. 362.) This suggests the "employing department" need not be a party to the contested contract to be considered "directly involved" for purposes of section 1090. While our analysis does not depend on this issue for its conclusion, it should be noted that the current state of legal authority on this issue would certainly permit a reviewing court to reach a different conclusion than stated herein.

[25] It is important to note that section 1090 does not recognize a "good faith" exception to its application. (*People v. Gnass*, *supra*, 101 Cal.App.4th at 1271.) Thus, it is no

defense to the section 1090 claim based on either the "non-interest" or "remote interest" exceptions. It follows that a section 1090 violation could be based on the participation of Board members Vattimo, Webster and Lexin in the adoption of Manager's Proposal II.

Although some question might exist in the Court's mind regarding whether the interests discussed above would be sufficient to support an order voiding Manager's Proposal II under section 1090, the adoption of the "presidential leave" ordinance[26] affecting Board member Saathoff[27] presents a significantly more probable basis for invalidation of the agreement under this statute. In addition to the failure to comply with the "disclosure" and "record" elements of section 1091.5, it appears adoption of this ordinance implicated only Board member Saathoff's interests, and therefore would constitute an "individual" contract, rather than a contract between two public agencies, such that neither the "non-interest" or "remote interest" exceptions could be applied. (*People v. Gnass, supra*, 101 Cal.App.4th at 1303; *Finnegan v. Schrader* (2001) 91 Cal.App.4th 572, 579-83.)

It is important to note that no published decision exists which analyzes the issue of a disqualifying "financial interest" under section 1090 under the particular facts of this case, i.e., enhanced pension benefits. The absence of controlling authority on this issue creates some uncertainty as to how a court would rule on the issue of whether pension benefit enhancements qualify as either a "remote interest" or "non-interest" under the exceptions to section 1090's prohibition against participation in decisions on which the public official is financially interested. However, given the potential

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defense to claim non-compliance with this section resulted from good faith reliance on advice of counsel (or in this case, failure of counsel to so advise).

[26] It should be noted that the evidentiary record supporting a nexus between adoption of Manager's Proposal II and this ordinance is significantly weaker than the nexus between Manager's Proposal II and benefit enhancements for regular union members. However, our conclusion in this regard is heavily influenced by the very broad application of section 1090 to such agreements, the evidence that the relevant agreements were adopted close in time to one another, and involved negotiation by the same parties. On the basis of such a factual and legal record, we do not consider it probable that a Court would be willing to extend any "benefit of the doubt" on this issue to avoid finding a 1090 violation.

[27] Case law is clear that the participation of one financially interested Board member is sufficient to support voiding the agreement. (*See, e.g., Stigall, supra*, 58 Cal.2d at 566-67.)

magnitude of the financial benefits imparted through such a transaction, we consider the absence of controlling authority on the specific issue presented to be insufficient grounds for concluding a court would refrain from invalidating the contested decision under one of the statutory exceptions to section 1090's financial interest prohibition.

We conclude it is probable the Court would void Manager's Proposal II on the grounds it was adopted[28] in violation of section 1090. However, the Court's order probably could not be extended to Manager's Proposal I (whose adoption similarly violated section 1090) because Plaintiffs' claim is likely barred by the statute of limitations. (*See Marin Healthcare Dist. v. Sutter Health* (2002) 103 Cal.App.4th 861.) The effect of this potentially anomalous result is discussed in subsequent sections.

F. Summary of Negotiations Culminating in Proposed Settlement.

Settlement negotiations were originally conducted exclusively between counsel for Plaintiffs and the City, beginning in approximately October 2003. Upon discovering settlement negotiations had commenced, we inquired of both counsel as to why we had not been invited to participate from the inception of negotiations. Each of the other parties' respective counsel claimed it was his counterpart's idea not to initially include SDCERS.

Our concern from the outset of the litigation was that Plaintiffs and the City would negotiate a deal which would have the effect of "settling around" SDCERS, such that the City gained the benefit of ending the litigation, and Plaintiffs gained the benefit of a substantial attorney's fee award, while SDCERS – the entity to which any monetary recovery would properly flow – would realize no benefit whatsoever from a lawsuit purportedly filed to "fix" the retirement contribution problem. However, when it became clear that any settlement the parties might possibly agree to would involve resetting the amortization period upon which the City's employer contribution is calculated – an action within the Board's exclusive jurisdiction – we were confident SDCERS' interests would be taken into account in any settlement the parties ultimately reached.

[28] Although beyond the scope of this letter, it should be noted that it would have been at least technically possible for the Board to vote on Manager's Proposal II without violating section 1090, if appropriate disclosures and abstention procedures were followed. (§ 1091.5 (a)(9), (13); *see also In re Mack* (1986) 69 Ops.Cal.Atty.Gen. 102.)

In early November 2003, we began participating in a series of meetings between counsel and representatives for all parties intended to produce a compromise solution to the issues raised in the litigation. Based on instructions from the Litigation Representative, we did not offer an affirmative proposal during the first series of meetings. Instead, we provided information regarding hypothetical amortization schedules, contribution methods and other aspects of proposed settlement structures from which Plaintiffs and the City created numerous settlement scenarios (an estimated 25 to 30 hypothetical contribution analysis were prepared during this six week period). The result of the first phase of negotiations was a proposal by the City, and agreed to by Plaintiffs' counsel, which involved (1) starting a new 30 year fixed amortization period in Fiscal Year 2005, (2) during fiscal years 2005 and 2006, contributions would be made at a rate lower than the actuarial rate derived from the new amortization period, plus an additional $14,000,000 in FY 05 and 06, (3) contributions would be made according to the "new" actuarial rate beginning in fiscal year 2007, and (4) the "delta" between the City's contributions and the "new" actuarial rate (FYE 05-06) would be secured by real property.

We presented this proposal to the Board in December 2003. The Board quickly recognized the City's proposal would amount to approximately $75,000,000 *less* in City contributions than SDCERS would otherwise receive under Manager's Proposal II. We advised plaintiff counsel and the City's representatives of the Board's rejection of the proposal immediately following the December 2003 closed session. Both the City and plaintiff counsel reacted quite negatively. Plaintiff counsel threatened SDCERS with further breach of fiduciary duty claims for refusing to cooperate with the City's settlement proposal, while the City's representatives took the extraordinary step of writing directly to the Board to suggest it had somehow been misinformed by counsel regarding the settlement negotiation process.

In January 2004, we worked extensively with SDCERS' Executive Committee and Actuary to develop settlement proposal that SDCERS would find acceptable. SDCERS Board directed us to conduct further settlement negotiations with the objectives of (1) resolving the litigation; (2) obtaining an outcome that was monetarily superior to Manager's Proposal II. Settlement negotiations were initially conducted under the supervision of the Honorable Howard B. Weiner, retired Justice of the Fourth District Court of Appeal. We presented two principal settlement scenarios, the first involving a split amortization schedule (15 year fixed for normal cost, 30 year fixed for UAAL), and the second involving a reset 30 year fixed amortization schedule, including updated actuarial assumptions adopted by the Board in February 2003, for FYE 2005-2008, following which the Board would be free to set whatever amortization schedule, and adopt any new actuarial assumptions, it deemed appropriate.

In the course of settlement negotiations, it became clear the determinative compromise would be on the amount of the City's contribution in FYE 05. The City representatives cited budget constraints relating to labor agreements which ran through Spring 2005 as the primary justification for the City's inability to make an FYE 05 contribution in the amount called for under the "hybrid amortization" proposal. In an effort to achieve the Board's directive of resolving the litigation in a manner which was monetarily superior to Manager's Proposal II, we thereafter focused on the limited 30-year fixed amortization proposal. A key objective in this regard was arriving at an actuarially based contribution schedule as quickly as possible. The City sought to make a FYE 05 contribution of approximately $110,000,000, instead of the $140,000,000 called for under the "limited 30 year fixed" proposal. In an effort to resolve what otherwise would have been a deal-breaking impasse, we agreed to communicate to the Board a settlement proposal calling for a compromise amount of $130,000,000 as the City's FYE 05 contribution, with all subsequent fiscal years covered by the settlement to require contribution of the full amount calculated by the actuary and approved by the Board for each such fiscal year.

Finally, because the settlement proposal *increased* the City's contributions over the following four fiscal years by an aggregate of approximately $75,000,000, we required that the City's annual employer contributions be secured by unencumbered real property for the term of the Settlement Agreement. The City agreed to this proposal, asking only that it have the right to substitute collateral during the term of the Settlement Agreement with other collateral of equal or greater value. Thus, the settlement negotiation process achieved the objectives of: (1) resolving all existing lawsuits against SDCERS; (2) invalidating any future enforcement of Manager's Proposals I and II; (3) increasing contributions to SDCERS over the following four fiscal years by an aggregate of approximately $75,000,000; (4) returning the retirement system to an actuarially based contribution method sooner than would have occurred under Manager's Proposal II; and (5) providing security for the City's substantially increased employer contributions during the critical first four years of the new contribution system.

G. Litigation Result Exceeding Settlement Value.

Fiduciary Counsel requested that we analyze the probability of a result achieved through litigation which conferred a greater benefit on SDCERS than is achieved through the pending settlement. It is important to note at the outset of this section that the settlement achieves substantially all of the most likely result which would come from a litigated resolution of this matter: (1) It substantially increases the amount of money contributed to SDCERS in the upcoming fiscal years, (2) it returns SDCERS to

an actuarially-based contribution method, and (3) it allows the Board to implement the most recent changes in actuarial assumptions significantly sooner than would otherwise be possible. Moreover, the foregoing benefits will be confirmed in the form of a judgment entered by the Court in the Consolidated Actions. The Court will retain continuing jurisdiction under Code of Civil Procedure section 664.6 for purposes of enforcing any term of the judgment against the City. (*See* Charter, Article I, sec. 1; *see also, Elyaoudayan v. Hoffman* (2003) 104 Cal.App.4th 1421, 1428.) Thus, the only means by which a litigated outcome could exceed the value of the negotiated resolution now pending before the Board would be a judgment for a substantial cash payment to SDCERS *in addition* to the foregoing benefits.

Under the circumstances presented by the *Gleason* litigation, there are three possible scenarios under which such a result might be achieved: (1) invalidation of Manager's Proposals I and II under Charter section 143 on a going-forward basis; (2) invalidation of Manager's Proposal II, with subsequent enforcement of the most financially favorable interpretation of Manager's Proposal I; or (3) an order directing the City to pay restitution to SDCERS in the amount of the "underfunding" caused by the three most recent years[29] of contract-based contributions.

1. Invalidation of Manager's Proposals I and II Under Section 143.

As discussed earlier in this letter, we consider it probable that the Court would grant Plaintiffs' Motion for Summary Adjudication, thereby invalidating both Manager's Proposal I and II on a prospective basis. In the event such a final judgment was entered in the *Gleason* litigation, the Board would thereafter be free to set whatever contribution rates it concluded were appropriate, based on its actuary's calculations and its evaluation of the appropriate financial burden to impose on the City. Under such circumstances, it is possible that the Board, based on advice from its actuary, would set contribution rates at a level higher than is provided for in the Settlement Agreement for the years covered by that agreement. Thus, it is possible that judicial invalidation of Manager's Proposals I and II could create a circumstance in which higher contribution levels could be set for some of the fiscal years covered under the Settlement Agreement.

The City would almost certainly appeal the trial court's ruling (the City's litigation counsel having stated as much on several occasions). Although we consider it

[29] Recovery of underfunding in earlier years would probably be barred by the three year statute of limitations governing Plaintiffs' claim. (*Abbott, supra*, 50 Cal.2d at 464.)

probable that the trial court's ruling would be upheld on appeal, the appellate process would delay entry of an enforceable judgment for a period of one to three years, depending on the City's willingness to pursue the issue to the highest appellate levels. In addition to the additional expense of litigating the issue on appeal, negotiations would almost certainly continue during the pendency of the appeal aimed at lessening the impact of the final judgment on the City's economic interests. Therefore, evaluation of the merit of this litigated solution must first be done in light of the near certain delay in implementing an economically superior contribution rate under authority of a final judgment.

Furthermore, in setting such a contribution rate, the Board would have to engage in an analysis of the City's financial condition similar to that already performed in the course of negotiating the Settlement Agreement. It cannot be overlooked that the Settlement Agreement sets a contribution rate for the City that results in an approximately $75,000,000 increase in employer contributions. This result was the product of negotiations with the City regarding its near term ability to pay increased contributions. Evaluation of whether the City could realistically meet its obligation for Fiscal Years 2005 through 2008 under an even higher contribution rate than is imposed by the Settlement Agreement must also be considered when analyzing the relative merit of the Settlement Agreement versus a litigation scenario.

Next, it is important to note that the City is required under the Settlement Agreement to provide collateral as security for the payment of the City's near term obligation to SDCERS. The collateral provides several benefits to SDCERS that would not be available under even the most optimistic litigation scenario:

- First, the proceeds from the sale (or sale/leaseback) of the collateral, of course, would provide additional sources to fund the City's obligations to avoid or cure a default event.

- Second, the liens on the collateral would preserve the priority of SDCERS to such proceeds against others creditors who might otherwise seek to obtain a lien on the collateral after the settlement.

- Third, the collateral provides additional rights to SDCERS in the event the City later seeks the protections afforded by Section 9 of the United States Bankruptcy Code.

Under the Bankruptcy Code, if SDCERS were only an unsecured creditor, the City would only be required to provide SDCERS with the same treatment under its plan for

the adjustment of the City's debts that the City provides to all other general unsecured creditors. Indeed, the City may not even be permitted by the Bankruptcy Court to separately classify or to solicit a separate vote from SDCERS on the plan of adjustment, and may be required to include SDCERS' vote with those of the City's general unsecured creditors. As a secured creditor, SDCERS would be separately classified in any plan of reorganization, would separately vote on the plan, and its secured claim could be treated differently than the claims of general unsecured creditors.

Moreover, as a secured creditor, SDCERS would be entitled to certain rights not generally available to unsecured creditors. SDCERS would be entitled: (a) to make a special election under 11 U.S.C. section 1111(b) to require, as a condition to the release of its lien in the collateral, that the entire obligation be paid in full; (b) to receive the value, as of the effective date of the plan, of at least the value of the collateral, and (c) to receive the "indubitable equivalent" of its claim. By contrast, the Bankruptcy Court has the power to confirm a bankruptcy plan of restructuring that does not provide for a minimum payment, or the payment in full, of claims of general unsecured creditors.

To guard against a subsequent administration's efforts to avoid paying an actuarially based contribution rate, we negotiated for - and obtained – $500,000,000 in new collateral as security for the term of the City's obligation under the Settlement Agreement. We concluded the fiscal years immediately following execution of the Settlement Agreement were most critical because the City would then be experiencing the greatest financial stress from the increased contribution levels. It is our expectation that the process of budgeting for increased contribution rates over the following four years will make the City less likely to react to the strain of further increases anticipated after the Settlement Agreement expires by attempting to avoid paying its full contribution amount. In crucial intervening years, the Settlement Agreement provides substantial security which would not be available under the first litigated scenario to protect against the same stresses that would be imposed by a judicially imposed increased contribution rate.

Finally, it should be noted that inclusion of $500,000,000 in collateral also addresses the "creditworthiness" issue raised in prior counsel's evaluation of Manager's Proposals I and II. The Settlement Agreement differs from Manager's Proposals I and II in two important - and determinative - respects. First, unlike Manager's Proposals I and II, the Settlement Agreement effects a substantial *increase* in the City's annual employer contribution amounts for the lifetime of the agreement. Second, the Settlement Agreement returns the City to actuarially based contribution rates, rather

than purporting to authorize a departure from this contribution method. Since the Settlement Agreement cannot be characterized as a "contribution relief" agreement, the theoretical basis for investigating the City's creditworthiness described in prior counsel's opinion letters is not present. Nonetheless, we recognized the significance of the issue given the financial strain imposed on the City by the Settlement Agreement's terms, and for that reason obtained security against its "default" in the form of $500,000,000 in real property as collateral to secure the City's contribution obligation over the lifetime of the agreement.

In light of the likely delay in implementing a different contribution rate under a court's judgment, and the uncertainty over whether such a contribution rate would significantly increase the City's employer contributions before fiscal year 2009, we consider the Settlement Agreement superior to the first possible litigated solution because of the immediacy of its terms, the amount of increased contributions which will be made thereunder, the return to an actuarially based contribution method, and the presence of substantial security during the critical first few years of substantially increased City contributions.

2. Selective Enforcement of Manager's Proposal I.

Another possible scenario in which SDCERS would receive a greater monetary recovery through litigation than through settlement requires a result in which the Court: (a) invalidates Manager's Proposal II, but leaves Manager's Proposal I in place, (b) rules that Manager's Proposal I is legally binding and enforceable, and (c) interprets Manager's Proposal I to obligate the City to make a one year payment of an amount sufficient to return the funded ratio to at least 82.3%, following which it would make contributions at the "contract rate" so long as the funded ratio remained above 82.3%. This scenario also requires some evidence that the City could pay such a judgment. For the following reasons, we view this as a highly improbable result.

It is technically possible for the Court to enter an order that invalidates Manager's Proposal II (via section 1090), but does not reach Manager's Proposal I (statute of limitations bar). However, it is important to recall our opinion that the probable result of this litigation is a decision by the Court, upheld on appeal, that both Manager's Proposal I and II violate Charter section 143, and are therefore unenforceable. As a result, we consider it unlikely that the Court would enter an order giving retrospective effect to Manager's Proposal I, because to do so would conflict with its conclusion that the agreement is unenforceable.

The improbability of this outcome is compounded by the fact the Court would have to not only find Manager's Proposal I enforceable, but also interpret it in a manner that

required the City to make a one-year payment sufficient to return the funded ratio to 82.3%. Moreover, this scenario would bear on the Board's comparative analysis of litigation versus settlement only if it was at least reasonably possible that the City could (and would) voluntarily pay such a judgment, rather than seek relief from either the gross amount, or the terms on which it was paid, from another court. The cumulative effect of the contingencies necessary to surpass the value of the proposed settlement makes the possibility of such a result remote.

3. Restitution By The City.

Plaintiffs have pleaded a claim for "restitution by the City of all amounts owed to the CERS' [sic] trust fund as a result of the City's past violations of law." In essence, Plaintiffs seek an award – to SDCERS – of the amount of underfunding resulting from contributions based on contract-based rates rather than the higher actuarially calculated rate. As mentioned above, the most probable outcome under this scenario would permit recovery of only the most recent three years of underfunding, due to the bar of the statute of limitations for earlier years. This amount is estimated to be between $90 million and $115 million.

We consider it probable that the Court will make the predicate finding to support Plaintiffs' restitutionary claim – that Manager's Proposal II violated Charter section 143. The question which would then be litigated would involve the proper amount of restitution to be paid by the City. Evidence (much of it technical and complex) would be presented as to the proper method of calculating the amount of past underfunding and the appropriate causal factors to be considered. While we consider it reasonably possible that the Court would ultimately enter an award of some amount of restitution, we cannot predict with any reasonable certainty what percentage of the current estimate would be awarded.

However, we can predict with some certainty that the City would appeal such a ruling, thus delaying payment for between 18 months and three years, during which further settlement negotiations would undoubtedly be conducted. Moreover, as we have warned in the past, a judgment of the size here at issue could prompt a future City administration to seek relief from the Bankruptcy Court, which would, at a minimum, delay, and possibly diminish SDCERS' ultimate recovery under this scenario. It is also important to consider, not only with this scenario but with all litigation scenarios, that SDCERS will continue to incur fees, costs and associated expenses in its effort to achieve a superior result through litigation than is available through the settlement under consideration. Although we have not undertaken a detailed fee and cost estimate as to the scenarios discussed herein, based on our experience with cases of similar scope and complexity, it is reasonable to estimate that litigation of this action to

completion – without regard to the possibility of achieving a superior result to settlement – would cost SDCERS between $300,000 and $500,000 in *additional* fees and costs.

CONCLUSION

The analysis set forth in this letter demonstrates the difficulty of predicting any outcome, let alone a superior outcome, with any reasonable degree of certainty. In summary, it is our opinion that a possibility exists of obtaining a marginally superior monetary outcome compared to the settlement pending before the Board. However, that outcome would involve a delay of at least eighteen months, and more likely closer to three years, before final resolution, at an additional cost to SDCERS of between $300,000 and $500,000. In our opinion, the immediacy, certainty, monetary value, and return of normal fiduciary powers to the Board of the pending settlement proposal, make it a superior resolution of the *Gleason* litigation than any reasonably foreseeable litigated result.

Very truly yours,

Michael A. Leone
SELTZER CAPLAN McMAHON VITEK
A Law Corporation

MAL:km/ejg

EXHIBIT 31

THE COMMITTEE ON
RULES, FINANCE AND INTERGOVERNMENTAL RELATIONS
OF THE CITY COUNCIL OF THE CITY OF SAN DIEGO
(MAYOR DICK MURPHY, CHAIRPERSON)

Agenda for Meeting at 9:00 am
Wednesday, February 12, 2003

COUNCIL COMMITTEE MEETING ROOM (12TH FLOOR)
202 C STREET, SAN DIEGO, CALIFORNIA

(FOR INFORMATION, CONTACT BILL BABER,
COMMITTEE CONSULTANT, AT 619-236-6330)

- ❑ **NON-AGENDA PUBLIC COMMENT**

- ❑ **APPROVAL OF THE RECORD OF ACTION ITEMS FOR JANUARY 29, 2003**

- ❑ **ITEM-1:** Quarterly Report from the San Diego County Water Authority's City delegation. (Approx. 30 minutes)

- ❑ **ITEM-2:** Retirement Board and Retirement System staff regarding Recommendations #2-3 made by the Mayor's Blue Ribbon Committee on Budget and Finance (re: pension and retiree health benefits). (Approx. 90 minutes)

- ❑ **ITEM-3:** Discussion re: Ethics Commission "clean-up" amendments to the Municipal Code. (Approx. 30 minutes)

- ❑ **ADJOURNMENT**

WILLKIE FARR and GALLAGHER

City of San Diego, CA

Rules Committee Meeting

February 12, 2003

[START TAPE 1 SIDE 1]

MALE VOICE: Okay, we'll go on to item 2 on our agenda, which is the Retirement Board and retirement system staff recommendations. Uh, let me just go through the, uh--the history--a little history here for the public as well as any members of the, uh, committee that weren't involved from the beginning. Uh, most of you will recall that in January 2001, at my first day at the city address, I, uh, announced an intention to set up a Blue Ribbon Committee on city finances. Uh, we were all--most of us were new to the council at that point. We wanted to try to identify where there were financial problems that the city should address. The Blue Ribbon Committee, uh, was appointed in April of 2001, came back with a report in February of 2002, identifying 10 specific recommendations. Uh, those recommendations were brought to the Rules Committee, and in 2002 we have addressed--we addressed some of the recommendations, um, and sent them on to the full council for approval. The--part of those 10 recommendations were the recommendations regarding the pension system. The Blue Ribbon Committee specifically,

uh, recommended first that the--we--that the city change its funding strategy to one that results in the city fully funding its future obligations, uh, including both pension benefits and health benefits, and second, the recommendation was to obtain a current and comprehensive analysis of projected pension expenses and revenue sources, uh, which includes the current present value of retiree health benefits to determine the future impact on city finances. The, uh--when that came to the Rules Committee, we referred it to the Retirement Board, asking them to give us a report on the questions raised by the Blue Ribbon Committee. I had really hoped we'd get this back in the fall, but we did, and so we are addressing it today, and that's how we've gotten to where we're at. The, uh--so I think what we need to do--oh, one other thing I wanted to say is this is a, um, significant, comprehensive issue. I do not expect that we are going to vote on something today. I expect we're going to refer this to the City Manager to, uh, make, uh, uh, recommendations as to how we should address the issues that are raised and bring it back to this

committee some time hopefully in the next 30 days or so, where we can, uh, uh, try to, uh, what, if anything, we're going to do to address the issues raised. City Manager?

CITY MANAGER: I--we would like to have 60 days, if possible. It is a very complex issue. As you see, uh, it requires a strategy on funding over the next five years and beyond that. So we can do it within 60 days, is what we'd like to do.

MALE VOICE: Sixty days is probably reasonable. Uh, I--but my--I think the point that I--you know, my belief is that we need to decide our course of action with regard to the pension plan system before we adopt a budget this year. I think that, um, given all the fiscal constraints the city's already facing, we need to know exactly what we're going to be doing about the retirement system, uh, before we adopt a budget for the fiscal year that starts July 1st, 2003. So I--60 days would still allow us to do that. It just backs us up pretty close.

CITY MANAGER: And if we can do it in a shorter period of time, we will.

MALE VOICE: All right, so Mr. City Manager, who's going to present the report?

CITY MANAGER: Yes, we have, uh, Fred Pierce [phonetic], the President of the Retirement Board, and Larry Grissom [phonetic], the Executive Director. So we'll start with Fred.

MR. FRED PIERCE: Uh, good morning, Honorable Mayor, and, uh, members of the City Council Rules Committee. Uh, it's a pleasure to be here. Um, as the Mayor has, um--has identified, I'm Fred Pierce. I'm the President of the Retirement Board. This is a volunteer position, uh, for me. Um, and I'm here together with our Chief Executive Officer, Larry Grissom, who most of you know, and the Chief Operating Officer of the system, Paul Barnett, to my right. Um, I'm going to frame some issues at the very beginning and then turn it over to Mr. Grissom to--uh, to comb through some of the details that are real important, uh, for you to understand, so that you can make the appropriate policy, uh, decisions on what to do with this information. Um, as the Mayor identified, we are here because of the, uh, Blue Ribbon Committee on city finances report and here to

respond to that. Um, that committee identified, um, two very critical, uh, questions, the first of which was: Is the city, in fact, fully funding the total cost of its retirement benefits? Uh, and second was the issue of retiree health care, and how is that being accounted for and being addressed. We will be addressing those as well as a broader issue. Um, and as a matter of fact, at the same time that the report was issued by the, uh, Blue Ribbon Committee, um, the Retirement Board was itself beginning a process of looking at the comprehensive, um, elements of not only funding the retirement plan, but also all of the complex contingent benefits that are outside the plan but that are financed as part of our operations. You're going to hear an awful lot about that later--later this morning. Uh, and to address both of those issues, I actually appointed a subcommittee of our Board to delve deep into these issues. Matter of fact, uh, in the audience, if you could just raise your hands. Uh, Mr. Dick Vortman [phonetic] and Mr. Ray Garnica [phonetic], uh, are here with us today, and they served along with myself on the

subcommittee, uh, that helped, uh, develop, uh, the report that you have in front of us. This report has been, uh, fully reviewed by that subcommittee as well as our entire Retirement Board. Um, and as with any Board that would 13 members, of course, you can have minority dissenting positions, uh, as-as you would undoubtedly know, but I can say that the information we're putting in front of you today does represent the consensus of our Board. And I think it's important for you to understand that. Uh, you may hear, uh, some minority viewpoints, but this is the overwhelming consensus of the Board. And as a matter of fact, most of our Board, knowing how, uh, significant the item, uh, in front of us is, is here today. And just so you can see, if all the members of the Retirement Board, uh, could actually stand, and you can see how well represented we are.

MALE VOICE: Why don't we just, uh, have everybody, uh, who's standing, just, uh, give us your name and--and what you represent, so we have it clear. We'll start with Mr. Vortman and go across the room.

MR. DICK VORTMAN: Dick Vortman, [inaudible].

MS. TERRY [INAUDIBLE]: Terry [inaudible], representing the [inaudible].

MR. DAVID CROW: David Crow, [unintelligible] retiree.

MR. TOM CASEY: Tom Casey, elected [inaudible].

MALE VOICE: [inaudible]

[inaudible]

JOHN [INAUDIBLE]: John [inaudible].

[inaudible]

FEMALE VOICE: [inaudible]

MALE VOICE: [inaudible]

MALE VOICE: Okay, thank you all for being here this morning, and I thank you for your continued service on the Retirement Board.

MR. PIERCE: Um, well, as you will see momentarily, the issues in front of us are extremely complex, and that's one of the reasons I'm going to have Mr. Grissom go through those details. Let me hit the high points of what you're going to hear, kind of start with the high points and then let Mr. Grissom kind of walk through, so you understand the implications

of these. Um, but first and foremost, I would say we are here today largely due to the performance in the investment marketplace. We are, uh, not unlike most other retirement systems in America, uh, that have been hit with the circumstances. You know it by looking at your own 401K or SPSP accounts. Uh, it is--it is very significant. Uh, that's the overwhelming, uh, factor that's impacting what's in front of us here today and what we need to address going forward. Um, in addition, um, a financing agreement with the Board, that's come to be known as first the Manager's Proposal back in 1997, and now we've referred to it as Manager's Proposal Two, uh, has in fact, um, structured city contributions such that they've been made at less than the full actuarial rate. Uh, that's also a contributing factor. That number is about $80 million since 1998. And if you actually, uh, accounted for accrued interest, uh, on that, uh, underfunding it, it--it eclipses just over $100 million, um, at our actuarial return rates. Um, per our most recent, um, financing agreement between the Board and, uh--and the city, this underfunding

will be ratably phased out between, uh, this next fiscal year and fiscal year 2009. So the underfunding on a ratable percentage each year will reach a point to where, in fact, it will be fully funded on a current basis by the year 2009. Um, during this period, and Mr. Grissom will explain what's all inclusive in these numbers, uh, if other actions are not taken, then what'll happen will be precipitous increase in the city's contributions from what, in fiscal 04, will be 108 million in total, not all from the general fund, and, um, the City Manager could speak to that, but--but from various sources, 100 million in total to a number estimated at $240 million by the year fiscal 09. So--so, no doubt, a very significant um, uh, ramping up. That could be brought down through other financing approaches, um, that, um, will be undoubtedly part of what the Manager will be reviewing in the next--uh, next 60 days. Um, you're heard a little bit or read a little bit about the funded status of the system. And, in fact, the investment marketplace has taken us from where we were 97% funded two years ago to where we're 77% funded based on our last

actuarial report. That does represent an unfunded liability of $720 million. Um, now the underfunding, because we're ramping up to full funding, over the years between now and 2009, and based on some assumptions that I'll let Mr. Grissom speak to, means that by 2009, we'll actually go from 77 to about 70% funded. So it will decline primarily due to the fact that we won't be fully contributing during that interim period. And let, um, one final thing on the financial status, um, which is there's been some play out there, uh, as to the significance of the city's contribution or underfunding pursuant to our agreement. If, in fact--and that's--I had mentioned that was a little over 100 million with accrued interest. If we had not had investment losses over the last two years like everybody else, that 100 million would be compared to a fund that, if we had 620, that 720 million that wasn't lost, was in the system, you'd have about a 97% funded ratio. So really, only about 15, less than 15% of the problem is actually the historical contribution shortfall. The 85-plus percent of the problem is actually recent performance in the investment

marketplace. So it's important to understand that, and our Board has kept our eye on the ball in that regard in terms of the financing arrangement with the city, uh, over the last several years. The last comments I want to make is you're going to hear an awful lot about contingent benefits today. I know you're familiar because we talked to you not too long ago about the 13th check, um, uh, which you authorized to be paid from a reserve account that, uh, is now depleted. Um, this is the first time in the Board's history, uh, that the payment of these contingent benefits is--has been placed in jeopardy by virtue of the investment marketplace. And it shouldn't go without notice that, um, having traditionally received these contingent benefits, the retirees have come to expect those benefits. And this council did send a message last year in connection with your action on the--on the 13th check to not expect it, but nonetheless, there's a whole host of these benefits that have been coming, uh, that they are expecting, and you just need to understand that, and then we need to think from--you'll from a policy perspective

how the contingent benefits are dealt with and addressed going forward. Um, uh, Mr. Mayor had asked--had asked about, as part of the Blue Ribbon Committee, to try to quantify what the present value of some of these were. Three of the main ones that you'll see are the 13th check. The present value of that future liability, uh, is $58 million. The second is the Corbett [phonetic] retiree benefit, which does accrue, but is only paid if there is surplus undistributed earnings. The present value of that benefit is about $75 million. And finally, the overwhelming issue of retiree health care, which currently is essentially, uh, paid on a current basis. Pay as you go is the funding method. If that were actuarially funded, uh, and you've seen this in the press of late, that present value is $1.1 billion, uh, to actuarially fund retiree health care, which is a contingent benefit and only paid through the retirement system if there are surplus undistributed earnings. Finally, there's been some--some talk of late about those contingent benefits and the funded status that I just talked about a few moments ago. Let me make it

very clear, there is not a correlation between the city's contributions and the funded status of the system and those contingent benefits. Those contingent benefits are paid based upon a measurement of current year returns, essentially realized cash returns. Whether the system is underfunded or not is not relevant to that. Um, if we lose money in a year, had we had more money in the system, it would have been invested in the same way, and we would have lost more money. There wouldn't be money to pay those contingent benefits. So it's important to disconnect those because there's been some miscommunication or misunderstanding that those are somehow related. Those are independent issues, and it's important to understand that. Um, and in closing, you're going to see lots of projections, and projections are based on lots of assumptions. And there's lots of different deviations that could occur in these assumptions. We've tried to put together a base-cased scenario that we think helps gives you the right snapshot. But please obviously, as you'd be aware, those assumption changes could change these forecasts and these outcomes,

um, so it's important to understand that. Um, so with that, I'm going to turn it over to Mr. Grissom and also say that, at the conclusion here, um, we're going to have a discussion from our perspective of where to go from here. The Manager will be able to take that and to address that. Wanted to kind of give you the executive summary at the front end. Now Mr. Grissom can kind of walk you through some history of how this comes about, what this really means, and then perhaps what some considerations for the Rules Committee would be. Thank you. Mr. Grissom.

MR. LARRY GRISSOM: Thank you, Fred. Uh, Mr Mayor, members of the committee, appreciate the opportunity to do this. I'd like to start by, uh, thanking Paul Barnett, who, uh, really took the laboring oar in putting all this report together, all 87 drafts, to get it to the form that you see it today. Uh, I would also like to thank Mr. Uvoragus' [phonetic] staff and the staff of the auditor and financial management, and the treasurer's office, who have assisted us in putting this together. Uh, would also like to comment, starting that my profession, like

any other, has its own trade lingo, and, uh, we all, of course, do this to impress people with how smart we are. Uh, if I use terms that you don't understand, uh, and don't explain them properly, please feel free to, uh, interrupt me so that we can understand it. This is a very complex thing, uh, this is, but what we're going to go into is Retirement 101, but it also includes a lot of Accounting 405 in the process of it. Uh, what we're going to do, starting out, who we are--SDSRS [phonetic]. We are the retirement system. We are responsible for administering and managing the defined benefit plans for the city, the Port District, and the newly formed Airport Authority. In our parlance, these are the plan sponsors. This covers all of their members that are broken into categories of general members, safety members, elected members, and then, of course, there are the retirees. Should indicate at this point, that from this point forward, you'll not hear me mention the Port District or the Airport Authority again. This--uh, this report applies specifically and solely to, uh, the city. The roles and responsibilities within this, as you

see, represented graphically there. The council creates the benefits, makes cash contributions, as actuarially determined to fund those benefits. We take those contributions, and they become assets. We invest them. We provide to you the pricing of the benefits through our independent actuary, and then we administer the benefits and distribute them to the members and retirees. By the charter, the Board is made up of 13 members, and you see the composition indicated there. Three are what we call ex officio. They are the offices of the manager, the auditor comptroller, and the treasurer. Four are appointed by the council. Three are elected general members. Two are elected safety members, one each of police and fire; and one is an elected retiree. What is the group, uh, that we represent with all this? As you see, it totals up to about 18-1/2 thousand people, which is, uh, comprised, as you see there, of both our active and--active members and retirees. Current status: As of December 31, we had $2.4 billion in total assets. What you see there is a basic asset mix of where those funds are invested. Should note, because there has been

some concern and certainly we have heard about it, uh, as you see, the amount of--the number of dollars there is pretty large. At no time in any of this discussion, is there any implication that any of the benefits, the defined benefit, that are paid to the retirees is in any jeopardy. What we're talking about is future funding and contingent benefits, which we will get into in a moment. Fred mentioned the investment markets. And this, as I told the Board, uh, last summer, is a good news/bad news proposition. Uh, if you look, in the top box are our returns, uh, over one, three, and five-year periods. In the bottom box is what the average public fund has returned again for the one, three, and five-year period. You can see that in each of those periods, we have done better than the average public fund. And the good news/bad news, as I mentioned, is that as of last June 30, uh, the bad news was we lost 2-1/2%. The good news is that we outperformed virtually every public fund in the country. For that time period, we were in the top 5%. Fred mentioned that there are a number of assumptions that, uh--that go into calculating all of these

numbers. We'll start, uh, with that. The target rate of return--the actuary, in doing the actuarial valuation, which is a projection of both assets and liabilities, assumes that we will earn, on a total return basis, 8%. As Fred mentioned, our current funding ratio at June 30 is 77.3%. This means that we have $3.17 billion in liabilities. What are those liabilities? This represents the amount of money, on a present value basis, that we should have in the bank in order to pay all of the benefits to those people currently retired plus all of the benefits that those who are still active members of this system have accrued and are assumed to accrue through their retirement and the rest of their lives. Our assets are, uh, market value of assets, which gets a little complicated to explain, but the actuary goes through a process, uh, to come up with this starting with our base, and there's a comparison between the book and the market value of 2.53 billion. You run those numbers, you come to the bottom line, as Fred said. Uh, we have an unfunded liability of $720 million. Now note, up at the top in the second line, that it says PUC funding method. PUC

stands for projected unit credit. There are six, uh, different means in the actuarial world of calculating liabilities. Projected unit credit is one of those six. It is one of the more volatile and one of the more aggressive. Uh, there is another one called entry age normal, that is less aggressive, more stable, and more expensive. Uh, the numbers that you see would be, uh, lower in funding ratio and higher in liabilities. We're reusing the EAN method. I mention that because there are some people who, uh, do feel that we should be under EAN rather than PUC. Okay, uh, why are we here today? As Fred mentioned, this is in response to the report from the Mayor's Blue Ribbon Committee on city finances. The committee expressed two concerns: Whether the city is paying out of its current year budget the full costs being incurred for the retirement system including health benefits and whether the budgetary process adequately comprehends the steadily growing annual expense. The committee had two recommendations. One was to change the city's funding strategy to one that results in the city fully funding on a current basis its

future obligations and secondly was to obtain a current and comprehensive analysis of the projected expenses and revenue sources, which include the present value of retiree health benefits, to determine the impact on the city's future finances. We'll go into--uh, we'll go into each of those things. The summary analysis is that, as you say--as you see there. The city is not currently paying out of the current year's budget the full costs being incurred for either the future pension or retiree health benefits. And secondly, there's a very significant growth in the required annual pension costs, which the city will have to deal with in its future budgeting. To give you a historical perspective, which we've touched on, the S&P--

[END TAPE 1 SIDE 1]

[START TAPE 1 SIDE 2]

MR. GRISSOM: --that you see there was 7 and a [break in tape] percent up to 23%. As Fred mentioned, as early as June 30, 2000, two years ago, we were at 97.3% of full funding. What's happened to the investment markets and to us in that period of time? Well, in 2001, the S&P was

down almost 15%. In 2002, it was down almost 18%. And as you see, we were down 2-1/2% in that 2002 period, which means that we certainly beat the, uh--the broad market, as it were. In addition during this time period, there was a settlement reached on the Corbett litigation that increased the liability 158 million, and the contingent liability for, uh, existing retirees is an additional $5-1/2 million a year. In addition, last year the council increased benefits for its general members. We have had a history of benefit increases going back the last 10 years. Okay. We, of course, benefited greatly during the unprecedented bull market, uh, as shown in the value of our--of our assets and as our funding ratio. We suffered in the investment markets when the tech bubble burst and the economy went south, and then, of course, the very negative impact on the economy of the events of September 11th of 2001. However, if you look at this over the long run, which is what we are charged to do, we have to look way out into the future, you'll see that, if you look at our average annual return through '92, we were up 14.34%, again against an assumption

of 8%. The 10-year period ending, uh, in June of 2002, we were still up 9.26% against an assumption of 8. Let's talk for a minute about corridor funding. Uh, this is what we refer to in our parlance as Manager's Proposal One and Two. The initial Manager's Proposal was, uh, begun--was agreed to in 1996, begun in 1997. Uh, from the standpoint of the City Manager and the city at that time, what they were looking for is the stabilization of their employer contributions, uh, to allow them to deal with their budgetary issues. The proposal allowed the city to contribute less than the actuarially, uh, computed contribution rate. This said that they would start--the city would start, uh, with the basis of the rate as it was actuarially computed in 1996 and then increase that by a half a percent per year until such point in time as the paid rate, as we call it, equalled the actuarially contributed rate. What happened with that? Well, as Fred mentioned to you, uh, the amount of money, uh, for that period of time, projecting through the end of this fiscal year, uh, that was not contributed, and then compounding that at our 8% assumption

rate means there was $102 million in contributions and earnings that would have flowed into the system that did not. That becomes then part of the problem. Uh, the Manager's Proposal Two then actually improved the first Manager's Proposal because the first Manager's Proposal was open-ended. As you recall, I said we're going to go up by a half a percent until we get there. In Manager's Proposal Two, the ramping up, which I'll explain in a moment what that means, actually requires the city to achieve the actuarially computed funding rate by fiscal 2009. Ramping up simply means that we take the difference between the actuarially computed rate and the paid rate and divide that difference by 6, that increases the paid rate. Then--that is this year. Next year, by 5, by 4, by 3, and obviously in the last year by 1. This takes all of the stuff that, uh, we have just described and puts it in graphic form. You see the bars on the left are our assets. The bars--in the dark blue bar is our liability. And then the green numbers at the top are our funding ratio over the period of time since 1998. You see that when the difference between

the light blue and dark blue bar is less, the funding ratio is higher. And then you see, as the difference increases, the funding ratio goes down. This simply gives you the dollar impact of the initial Manager's Proposal and shows you the numbers, how the, uh, the $102 million, that I mentioned before, was arrived at. Then you look at the historical funding ratio for that period of time and you'll see that, in spite of the Manager's Proposal allowing under-contribution to this system, for a period of time through 2000, the funding ratio actually increased. It stayed pretty stable for a period of time and then increased. This was due to the great investment returns that we were having in that period of time. The bottom, in common parlance, dropped out of the investment markets about three years ago, in March of 2000, and has gone down significantly since then. And you can see the impact that that has had on our funding ratio. Okay. Now, let's talk about what Fred mentioned as the contingent benefits. There are five things listed here. The only two of those five that are direct contingencies are the second and third, the 13th check and the Corbett

payment. Contingent benefit, there's a big, long definition in the municipal code as to what constitutes realized earnings, but basically this is the income that you receive from BONTA [phonetic], pay-downs from dividends on stocks, from payments on real estate, and the net of gains and losses on the sale of securities, i.e., the gains and losses on the sale of stock. The muni code says that you figure all this out in a given year and then it sets a priority order of things to be done with that money. In that priority order are all of these things, but the two, the 13th check and Corbett, at this point, are the only ones that directly impact the number of dollars that retirees receive. As Fred mentioned, this year the 13th check was paid because we had created a reserve to cover one year's worth of that payment when, if you will, the times were good, and the council authorized us to make that payment. Back, back up to it, uh, Paul. The Corbett, uh, payment is again dependent on earnings and does differ from the 13th check, in that it says in any year that, uh, the earnings are insufficient to make that payment, it will accrue to the following year.

Health Insurance, the supplemental COLA reserve and the employee contribution reserve are things that are--have a feature of contingency dependent on earning, but we'll get into explanation of those in a minute.

MR. PIERCE: And Larry, I was just going to add to that that one of the quirks of this issue of realized earnings is the fact that we operate the fund on a total return basis. We're investors for the long run. That's a calculation of settled transactions in a given year. We could have a year where we'd have negative realized earnings and a positive total return or vice versa. And it does cause problems for us, the fact that we use this as a measurement to pay these contingent benefits because in the long run it means we've got to earn a greater return to be able to pay for those contingent benefits in years where the earnings are positive. But I just wanted to [crosstalk].

MR. GRISSOM: Thank you, Fred. That's a good point to remember. Realized earnings, realized return, and total return do not track in locked step. They could both go up, they

could both go down, or they could move up and down independently of one another. This gives you the history of our realized earnings, uh, since 1999. And, you know, I call out to you specifically the two numbers. In 2000 the number was 416 million. Last year it was 51 million. Currently, through November 30th, it's negative 55-1/2 million. Why is that? Because of the market conditions, our portfolio is, in the common parlance, under water. That simply means that the book value of assets is greater than the market value of assets, so that when one of our money managers sells an issue, we realize a loss, okay.

MR. PIERCE: And Larry, you might just also mention that just the fact--if you could go back to that slide, Paul--just the fact that there are realized earnings in a year, 2002 had realized earnings, the municipal code essentially encumbers that, where we have to first credit our reserve accounts, the employee and employer contribution reserve accounts, and account for the operating budget of the system prior to there being surplus earnings to pay those contingent benefits. And with that, the

51 million was woefully short to pay any of those last year.

MR. GRISSOM: That's correct. The total of the crediting of employee contribution accounts in the payment of our budget was approximately 59 million. And as you see, we only had 51 million. That's why the other things that were contingent upon that surplus earnings simply did not get paid. And as you're seeing, the situation almost certainly will repeat itself again this year. This gives you an idea of what those contingent benefits are, what the annual cost is, and the number of retirees who are currently receiving that benefit is. Now is when it starts to get a little bit complicated. And I apologize. This is a little bit of a busy chart, but we needed to, uh--to try and put it all together. What you see is all of these benefits and the contingent upon earnings, and in response to, uh, what the Blue Ribbon Committee asked for, what we have attempted to do is give you projected pricings. As you'll see, health insurance, which was initially begun in 1982, has received out a payment through June 30th of almost 57 million. The last year's

payment was 9-1/2. This year's projected payment is going to be in the vicinity of $10 million. Projected liabilities, present value in today's dollars. The actuary assumed that each eligible retiree would receive a health insurance payment of $6,000 a year. He assumed that all current retirees would be eligible to receive--all current active employees, rather, would be eligible to receive that. And he also assumed that the cost of premium would increase at the rate of 5% a year. The $6,000 is the highest of the, uh, various insurance payments, and the average is probably less than that. However, premium costs have been increasing at the rate of 13 to 15% a year, so his projection there is somewhat low. Uh, you put those two things together, this means that in order to pay the current and future liabilities for health insurance, in present value, today dollars, we would have to have $1.1 billion. Talk about health insurance a little bit more, uh, in a subsequent section in terms of the financing. The 13th check has paid out 58 million. The last year it was approximately, uh--was just short of $4 million. The, uh, actuary has projected the

present value dollars again to pay that for all those currently and in the future eligible would be 58 million. The Corbett again shows the same things and a liability of 75 million. The employee contribution rate reserve and the supplemental COLA reserve do not have liabilities associated with them because that's not the way they were defined. The employee contribution rate reserve started with a, uh--an amount of $35 million. I believe we did that in 1998. The intention was to pay out of that reserve a portion of the contributions due from employees. We then credited it with earnings at 8%. And for a period of time, the actual earnings credit was sufficient to pay the amount that was due back out of it. That has been increased, uh, from a total of 0.65% to where it will ultimately be 3-1/2 to 4% of total payroll. And we're projecting that if we do not credit that, that that reserve will run out in as little as two or three years. The supplemental COLA reserve was established at the same time with a like amount of $35 million. Its purpose is to pay retirees. At this point, the group who retired prior to June 30 of 1982, with the

amount necessary to, uh, maintain the purchasing power of their retirement benefit at 75% of the dollar that they are--that they are--that they retired with, I guess is what I should say. As you see, that's about 2.8 million. It was also to be credited, uh, with earnings at 8%, and it was, when the earnings were available to do that. And that reserve's principal amount pretty much stayed stable during that period of time, uh, again, without crediting it. It will--uh, it will eventually go away. We think--and this is an actuarial projection, but we think that there is sufficient money in there to continue that payment for that frozen group of people for the rest of their lives. Okay, projecting all of this into the future and again attempting to put, uh, numbers to it. This current year the contribution just for the pension system was $54 million or 10.33% of payroll. The city also paid another 28 million on behalf of employees. This is what is called the offset. Basically, the city pays amounts varying from, uh, 5% to 7.3% currently of employee contributions. That 78 then gets added to the 54 for the total cost. By 2009, assuming

that payroll increase is compounded at the rate of 4-1/4% per year and assuming that the actuarial contribution increases 3% next year and 1% each year thereafter, the payment of just the, uh, the pension side, the 54 million, will grow to 197. If the contingent benefits were also paid, assuming that there are no excess earnings, it would cost, at that time, another 57 million, to a total of 254. This represents, uh, everything that we have just talked about on a graphic basis, the lighter colored bar being what we call the paid rate and the darker colored bar being the actuarially computed rate. And as you see, it is short now, but in accordance with the existing Manager's Proposal, those two bars equal each other in fiscal 09. This one gets really complicated. It does put together the actual total number of dollars that the city has, uh--has contributed. We went back to 2001. Again, you look three down at 2003, and you see the numbers we talked about before, where you have $54 million to the pension system. You have another 28 on the offset. You are contributing $1.2 million to the city's drop accounts through the current year. Total cost is

actually 83--a little over $83 million. That grows in 2009 to a total of nearly 240 million. Then you have the issue of the employee contribution rate reserve, which is what the asterisks are there for. If the reserve is used up by 2006 and if the council agrees to continue paying those as offset, those numbers will increase by another 16-plus million dollars a year and make the total nearly $258 million as opposed to the 240 that you see there. Yes, Fred?

MR. PIERCE: And Larry, I just wanted to add one perspective here, which is that the city employer contribution numbers that are growing exponentially, a material portion of that, it's really two elements. One is the normal cost of the retirement benefits. The second is amortizing the unfunded liability. So, as we get on later and as the Manager looks at strategies in regards to the unfunded liability, if that unfunded liability shrinks, the contribution rate is reduced, and these numbers in future years go down as you get a different funding ratio. So it's important to understand that.

MR. GRISSOM: That is true. Uh, just a little definitional thing. Normal cost is the cost of the benefits that are accrued today and paid for today. The unfunded liability, of course, is the difference between assets and liabilities, and it is amortized--our current amortization period has, uh, 19 years, uh, left in it, so you're amortizing that $20 million over a 19-year period of time. Here are the funding projections. This chart again takes everything that we just, uh, showed you in terms of numbers and shows them graphically. Here we get into, uh--we get into funding ratio and what you see is what the funding ratio will be, uh, with the ramping up of contributions that we discussed before. Here again it is an important thing to know. Everybody talks about full funding, and one thing we need to distinguish is the difference between a public pension plan and a private pension plan. We are assumed to be in existence for forever. And a funding ratio, as you see, in 2009 of 70%, uh, is not full funding. But as long as the full actuarial contributions are made, if you were to take this chart and then project it out another 10 or 12

years, you would see the pattern reverse and go forward, again assuming positive investments and so on and so on, and so forth. On the private side, there's a thing called ERISA, which I assume we're all relatively familiar with. It calls for a corporation's pension system to have what we call a planned termination liability. In other words, you have to have enough money in the bank to pay for all the benefits accrued and vested if the corporation were to go out today. That means then that they--that, uh, ERISA requires that a private pension plan be fully funded 100%. This is why you read in the papers that IBM took a 1.8 billion-dollar write-off to fund their retirement plan and so on and so on, and so forth. I told you we would talk about health insurance. Uh, here again the current benefit provides for the payment of those--the health insurance premiums through the retirement system out of the so-called surplus earnings. There's a very complicated formula, and I won't go into the tax code of the amount of money that you can use for this purpose. Uh, that amount of money in years past has been greater than what the premium has--cost has been. We have

therefore built of a reserve in the health insurance, uh, reserve. Uh, without crediting that with any additional earnings in future years, we estimate that those reserves will be gone in two to three years, depending upon what happens to premium cost. There is another amount, uh, in another trust that is pending, that could extend that for another year and a half or two years. Uh, the current cost, as I said before, is approximately $10 million a year. Uh, that will likely increase, and I believe we've got a chart in here somewhere to something on the order of $15 million, uh, by the time that, uh, 2009 rolls around. A very important point to make here. Since its inception, insurance, and that was 1982, retiree post-retirement health care, retiree health insurance has been on a pay as you go basis. It was not designed go be actuarially funded and it has not been. In fact, the way the muni code currently reads is that if all the reserves are gone and there are no earnings, then that becomes a part of, uh, the budgetary obligation of the city. Uh, the numbers that we have given you, uh, are assuming that health insurance were

a pull-on responsibility of the retirement system and therefore were actuarially funded. Uh, to my knowledge, and I'm sure that, uh--that your staff will discuss this with you extensively at some point, but, uh, to my knowledge there is no requirement that health insurance benefits be fully funded, not to say that--be actuarially funded, I should say. Not to say that this would be a good thing to do, okay. Here again we're projecting the total of all of the stuff that we have just told you about. Uh, our current unfunded liability is, uh, 720 million. The 13th check and health insurance for current retirees has a projected liability of 433 million. Uh, retiree health insurance for those that are currently active, that will retire in the future, has a projected liability of 750 million. And then the contingent liability of the Corbett benefit of 75. The total adds up to nearly $2 billion, which is a large dollar. Okay, uh, we're now at the point to analyze alternatives or to discuss alternatives, and I wish to make the point here. We, as the retirement system and the Retirement Board, simply put these to you as alternatives.

Uh, what is done is, uh, the policy call on the part of the city and the city council. It is not our point--or not our place to recommend to you do, you know, 1, 3, and 5, but do not do 2 and 4. But we discussed these out, and I'll turn it back to Fred for that discussion.

MR. PIERCE: Uh, yeah, thanks, Larry. These are pretty self-explanatory as put up there. But essentially under number 1, if, uh--if the council were to maintain the status quo, then the contribution rates ramp up pretty aggressively over the next half a dozen years, um, but at the end of that timeframe, there would be--you would still--you would then be at the full, uh, actuarial rate as determined by PUC. Understand, if you did that, the issue of the retiree health benefits still being on a pay as you go basis, is an addition, um--in addition to that item. Um, something that many other, uh, pension funds have done, together with their plan sponsors, is issue pension obligation bonds. Uh, that's where you float bonds. You take that money. You fill it into the system, whether it's in the full amount or some other amount, and that reduces the unfunded liability,

which then reduces the contribution rates, um. And there are issues of what the costs of those bonds are versus the costs of the accrued liability, um, that need to be evaluated, um. The third alternative is, as was reflected, even though the contributions are being ramped up over the next six years, they are still nevertheless underfunded. Uh, actuarially, each underfunding is accruing, uh, at a rate-- actuarial rate of 8%. So you don't pay 50 million this year, you know, then it's 50 million plus 4 in accrued interest the next year, and that number just tends to affect the unfunded liability. There could be an agreement to change that, to increase more immediately the contributions. Uh, that would also have an impact on the figures. You can obviously combine these. And we trust that as--um, as the Manager and staff evaluate these, there will be a plethora of other alternatives or, uh, strategies, um, you know, that could fall within the range of these or others that might, um, that might come up, um. Uh, the last one was a comment I had made earlier, which was the, um, permanency of, uh, members' and retirees'

expectations in regards to contingent benefits, uh. And there is some question as to, um, whether the current system of using, um, realized gains as the mechanism to pay those may call to a threshold question. Do those want to be benefits or do those not want to be benefits? And if so, should they be actuarially funded, uh, or should they be allowed to be funded in the manner that they are today? And the health insurance question, obviously a very significant one being a pay as you go plan, so. Uh, just that's the final kind of food for thought in terms of, um, what the conclusion of the analysis is.

MALE VOICE: Okay, we'll take a five-minute break and come back at 10:30 for, uh, public testimony and comments.

[break]. [background talk]

MALE VOICE: Council member Mainchen [phonetic].

MR. MAINCHEN: Here.

MALE VOICE: Council member Peters.

MR. PETERS: Here.

MALE VOICE: Deputy Mayor Azunza [phonetic].

DEPUTY MAYOR AZUNZA: [inaudible]

MALE VOICE: Council member Medafer [phonetic].

MR. MEDAFER: Present.

MALE VOICE: All present.

MALE VOICE: All right. Uh, we're going to go first to, uh, there are five public speakers. Uh, each person gets three minutes. Uh, we'll start with Nancy Acivero [phonetic], uh, followed by Judith Folsom [phonetic].

MS. NANCY ACIVERO: I'm Nancy Acivero, the current President of the City of San Diego Retired Employees Association. And I just wanted to say I really appreciate the concern that the Mayor and council are showing to this issue and particularly that you are looking to resolve it within the next 60 days or so. And, uh, we, of course, would love to see the system made whole and the contingent benefits provided for, particularly for the older retirees. And if there is, uh, anything within this--this process, that we were invited to participate in, we would welcome, uh, that invitation. Thank you.

MALE VOICE: Uh, Judith Folsom, uh, followed by Judy Italiano [phonetic].

MS. JUDITH FOLSOM: Uh, my name is Judith Folsom. And I would first like to thank you for supporting the payment of our 13th check last year. It was greatly appreciated. And today I'm here to ask for your continued support. A major issue affecting retirees is the retiree health benefit. A city resolution and city ordinance adopted in 1981 clearly state that the medical insurance is on the same basis as is provided to city employees, uh, and that it was provided to us as a permanent benefit in lieu of Social Security participation. The document states that is was the intent to provide such coverage as a permanent benefit for eligible retirees. The city has not reentered the Social Security system. The benefit is still permanent, and we ask--and I ask that you please fund it as such. As indicated in my letters to you, I am also asking you for permanent funding for our 13th check in Corbett settlement. Currently, these contingent benefits are paid from surplus undistributed earnings. Their continued payment is threatened by the interest credited to drop participant accounts. The interest credited is deducted from surplus

undistributed earnings before our contingent benefits. Every dollar credited to drop--to a drop account is one less dollar available to pay contingent benefits. The average drop allowance reflected in the June 30th valuation is approximately $51,000 a year. An employee can work for the city for a maximum of five years while in drop. At the end of the five-year period, his account would have grown to $311,000. He can leave his drop monies on account with the system indefinitely after he quits. If he leaves the monies on account for just five more years, the account will have grown to $464,000, including over $35,000 in interest earned during that last year. The interest is more than twice the average annual general member retirement allowance of $16,400, and that $35,000 in interest is deducted from surplus undistributed earnings before any of our contingent benefits. As of last June 30th, there were over 500 drop participants. Over $6 million was credited to their accounts. An additional 1800 employees are eligible to enter drop within the next five years. Based on today's dollars, the average--the estimated

average retirement allowance of these potential drop participants is over $63,000 a year. Even if 75 to 80% of those who are eligible actually enter drop, the amount of interest credited to the drop accounts will be huge. Now, the interest credited to drop accounts is different than the city's drop contribution rates that was--that was addressed, uh, in the presentation. Please remember your older, loyal retired city employees and find permanent funding for all of our contingent benefits. Thank you.

MALE VOICE: Judy Italiano, followed by Michael Ageri [phonetic].

MS. JUDY ITALIANO: Good morning, Mayor and council and Manager. Uh, judging by the number of phone calls I've gotten over the recent newspaper articles, I can imagine what your offices are like, a lot of calls from a lot of people that are very confused, upset, and afraid. And, uh, it's unfortunate that we have to find ourselves in this situation. The complexities of the system are easily manipulated to suit agendas. And certainly, you've found through phone calls and what you're

hearing today, there's a lot of agendas that are taking place around this particular issue. The important thing that I've put out in my messages on the phone is that no one's vested retirement benefit has been threatened, uh, that this system is, uh, $2.53 billion strong, and the scare tactic that some retiree is going to lose their vested benefit is really--uh, really sad because, uh, that's not true. MEA is proud of the accomplishments that we've made in bringing about the appropriate improvements in benefits to keep pace with state and county comparable improvements, and we've always done that at the bargaining table with the overall help of the system, uh, in mind. And our negotiating team has spent many, many hours with Mr. Grissom, understanding how the retirement system works, as well as with the City Manager's designee to come and explain those things to us. Despite rumor and hype to the contrary, uh, improvements in active employee benefits did not cost retirees their 13th check this year. Contingent benefits depend, as just heard, on the investment earnings, and those earnings were dramatically, uh, down in the last few years.

Also the Corbett check is a contingent benefit. And retirees were represented by the same attorney that's suing the system now, and he knew full well that those payments were contingent on investment earnings. That has not changed. Finally, the MEA understands that you, as the Mayor and the council, inherited, uh, the first Manager's Proposal and a huge, uh, problem on how to deal with retirement benefits. And we know that with the strong leadership that all of you have been showing us over the last few years, that you're going to deal with this problem and get it resolved, and we appreciate your continued work on it.

MALE VOICE: Thank you. Michael Ageri followed by Jim Gleason.

MR. MICHAEL AGERI: Good morning. I began my career as an attorney prosecuting, uh, pension cases. I worked for the United States Senate Subcommittee on Investigations and investigated the Central States Pension Plan. And between 1994 and 2000, I have represented 8,000 people throughout the State of California to recover their losses in a company called First Pension. What I learned from that is the

most important person for you to be talking to right now is the actuary. Uh, we need to readjust benefits. We need to readjust our investment policy because it's too much dependent on the stock market. We need to make sure that we have up-to-date information. Getting information as of 6/30/2002 really is almost useless, because that doesn't tell us anything about today, February the 12th. That's what we really--the latest information you have is as of December. Uh, it's 720 million now. The--what has happened is, it's true--I don't think there's any villains, but what's happened is that, as the stock market has gone down, we didn't radically enough adjust our investment policy, and so we continue to get hit by that. It may be necessary to radically adjust our investment policy. We may have to take care of our benefits. But the key mistake that's being suggested to you is that this all can be taken care of in the outer years. If we don't adjust benefits, if you don't adjust the outgo, if you don't adjust in the most prudent way possible, the outer years are even going to be worse than these years, and the idea of later generations

taking care of these problem. What I suggest that we do is this. First of all, it's not your problem. You know, there were--you did vote for something last year, but I don't think it was sufficiently in front of you to make as informed a decision as we have today. But what I suggest that we do is this. Create a task force of experts. Bring the actuary in. I'm disappointed to see the actuary isn't here today. In the Justice Department, the thing they taught us was the actuary is really the most important person to talk to. Create a task force and then commit ourselves to say, look, we're not going to spend any more money on stadiums or whatever until we solve this problem, because this could really blow up and become a huge problem. Eight percent--the assumption of 8% is a huge assumption that we cannot make in light of where the stock market is headed right now. And so, by an order of magnitude, you are--you probably have a much bigger problem than you think or that has been presented to you. So I say get accurate information that's up to date. Create a task force. Mayor, don't try to solve the problem in

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this budget year. It's taking on too big a responsibility. This thing was created by people before you got here for many years. Don't try to solve it all in one bite. But that would be my recommendation. And again, I don't think it's necessary to find the villains. This is a problem that everyone's struggling with all throughout the United States, but we need to make change, and we can't continue on with life as usual and expect we'll have a sound system. Thank you.

MALE VOICE: Uh, Jim Gleason.

MR. JIM GLEASON: Thank you, Mr. Mayor, members of the committee. It's unfortunate that this has come to this point, but it's kind of grown gradually since 1991 through a series of kind of manipulations that looked like creative financing, that looked good at time but have now proven to be pretty disastrous. A couple of things that came up today. Mr. Pierce indicated that because of one year the system had lost money, there were not sufficient funds in the system to pay for the--some of the contingent benefits. That was one year. Mr. Grissom followed that up by saying, over the last three

years, it hasn't been that bad. We've had a positive. So five years, quite positive. Going on back several years, it's been a dynamically performing system. My problem that I'd like to talk to you about is that the system has been managed in the interest of the city and its contribution rates and of current employees and the vastly increased benefits they've been given, without consideration to retirees and their contingent benefits. Even it was discussed with you today that the contingent benefits may be something less than legitimate. Mr. Mayor and members of the council, these are the result of court actions requiring the city to do this, and it came back that this was the agreed upon way of dealing with this. The city council--previous city councils had come to that commitment. It was a way of doing it. And it was--it was--it could have been taken up on many different forums. It could have taken on another 1% increase in cost of living and so forth. It didn't. The 13th check took on that character. You're talking about something that was created by the city. It was--it's not just an afterthought of a benefit. Uh, I think this

thing can be managed. It's going to be very difficult. Frankly, it's very difficult for the present Retirement Board of administration to administer this equitably in the interest of all members of the system--the provider, current employees, and retirees, when the majority of the voting members of the trustees are current members who have vastly benefited since 1996, vastly. And now we see that retirees are having damage done. That's about it.

MALE VOICE: Uh, David Wood.

MR. DAVID WOOD: Mr. Mayor and members of the committee, my name is David W. Wood. Um, I worked for the city for over 31 years. And, um, I just want to say that I'm rather ashamed of the situation, and I'm--I think the city should be ashamed and I think the Retirement Board should be ashamed because it shouldn't be necessary for two old retirees to come back here and try to defend their benefits that were, I think, legitimately earned. And I think we've been manipulated out of them, and I think it's unfortunate. And I think the city should take corrective action as soon as possible. Thank you. And restore some sense of confidence in

the retirees and the financing of the city.

MALE VOICE: That concludes the public testimony. We'll go to the council members for questions. Uh, Mr. Medafer.

MR. MEDAFER: Thank you, Your Honor. I think the last speaker kind of summed things up, uh, with one word, and that's confidence, and confidence is certainly lacking this morning, uh, from the recent newspaper articles. And I brought with me today a number of questions that, uh, I may not expect to get answers today, but I nonetheless hope to get answers to, and I think the public deserves to have answers to. I have several letters that, uh, I pulled from my files, that I have been saving on this issue, going back to last May 2002. And Ms. Schipioni [phonetic] wrote a letter asking for--

[END TAPE 1 SIDE 2]

[START TAPE 2 SIDE 1]

MR. MEDAFER: And, you know, am I reading this right? Two billion in the hole by 2009?

MR. PIERCE: Well, let me answer, and then Larry, you take it. The other part of this is the definition of contingent benefits. We have never been asked to fund those. They are paid

if there are surpluses. So, a big chunk of this is those contingent benefits, Mr. Medafer. About a billion two of that--no, a billion--well, everything but the 720, um, are the contingent benefits, that are, in fact, now being, uh, seen as that word infers, contingent, and so it takes extra earnings to pay those. So it's a policy decision. But if, in fact, the council wanted to formally make those permanent, then, in fact, this is the picture, if you wanted to do that, if you wanted to allow [crosstalk]--

MR. MEDAFER: Well, I'm sure we have a lot of employees that have some expectation on that. That's my concern.

MR. PIERCE: Yeah, that's why we tried to make that--yeah, I concur.

MR. MEDAFER: And again, I'm looking at this chart. I don't see anything in this chart about the stock market today or tomorrow. This just shows what the bill is going to be. Uh, so again, if I read that chart wrong--you know, I noted in my notes here, without the depressed market, you still--if we were to pay these benefits, that's $2 billion. Corbett, I

understand, is a legal settlement, is it not? Aren't we legally obligated to pay that?

MR. GRISSOM: That is correct, Mr. Medafer. It is--all of the benefits, as Fred mentioned, everything on that chart, except for the 720, is a contingent benefit. In other words, it is contingent on there being sufficient realized earnings to fund it. The numbers that you see there are present value dollars of the--with a snapshot of the conditions in the system as of June 30, uh, that are how many dollars would have to be in the bank today to ensure that you had the money to pay those benefits regardless of what happened out into the future. That future projection does assume a growth at 8% average over the long term. That is correct.

MR. MEDAFER: That is my--a very big worry. Uh, how about slide 24, please. Slide 24, we talked about health insurance. And on that second line there, what I was struck by is that, for the last 20 years, we've paid 56 million. Yet, in the last two years, two fifths of that or more than two fifths of that has been paid in health. Now, that ought to freak anybody out. And I'm again concerned--and again, I'm asking

these questions at this point rhetorically, because when I conclude, I'm going to offer a suggestion--uh, but, you know, I'm a City Manager, uh, you know. Ten million dollars projected for 03, 9.5 last year, and over the entire 20 years, since we got out of Social Security, we've only paid, you know, not even $60 million. Um, let's go to slide number 9. On slide number 9, this is another concern. We show total liabilities of 3.17 billion, and this is how you have your 720, uh, million. I guess my question at the time--and maybe it's been answered, but I'm going to ask it again--does this 3.17 billion include health benefits?

MR. GRISSOM: No, it does not.

MR. MEDAFER: Oh, okay. Well, that's another concern. Again, going back to health benefits. Um, another issue that I got from my conversation with Ms. Schipioni at the beginning of the year, was that in the area of capital gains, um. Tell me if this is right or wrong. Capital gains are distributed thinking of them as cash, and that money is not kept in the plan or not being reinvested. Is that true?

MR. PIERCE: Well, the issue of realized

gains is just that, Mr. Medafer, that in the goods years--you know, picture peaks and valleys--to pay these contingent benefits, in the good years, money is taken out of the system to pay those and doesn't stay in the system to pay the vested benefits over time. So what that really means is that if our target rate of return is 8%, but in the years we earn 9, 10, 12, we're taking some of that to pay those benefits, it means we really need to earn more than 8% over time. And that is absolutely accurate.

MR. MEDAFER: Okay. Um, so the underfunding issues of concern. Um, in a letter that was not responded to--at least, I didn't, as a member of the city council, get a copy of this, was a letter from Ms. Schipioni dated 23 May of 02, um, where she indicated, um, a comprehensive performance and operational audit, she was asking for that, of the retirement system, similar to the one recently done by the metropolitan government of Nashville and Davidson County Employee Benefit Board, to be conducted as soon as possible for the purposes of providing an independent assessment of the

condition and performance of the system. And it goes on to talk about performance of the pension fund investments, including but not limited to the investment consultants, managers, custodians, brokerage firms, etc.; and then phase two, assess the employee benefit delivery system, including the administration, and on and on in a number of issues. Um, I saw the audit statement in your annual report signed by Victor Colierone [phonetic], but it is my understanding that all he's doing is just simply saying this is a nice set of financials, but it doesn't say much beyond that. Is that correct?

MR. PIERCE: Yes. In fact, um, the Board did, um, around the timeframe of Ms. Schipioni's letter, take several very significant action items in regards to, uh, auditing of the system. The first is the Board has acted and has now created, um, or approved the creation of an audit committee. Uh, and, in fact, we are now going through the formative, uh, policy of setting up the rules necessary for that to become, uh, an ongoing standing committee of the Board, and that--those rules, I believe, are going to be adopted, uh, next month at our

Board. So we're creating the audit committee. I will then appoint that committee. The Board has also approved an even broader scope of, uh, an audit than was recommended in that letter. And so, we're simply waiting for the audit committee to be set up, for them then to fine tune the scope of that. But we will be having a broader investment audit, um, than just the financial audit you see there, um, Mr. Medafer. We'll also be having an operational audit, which is a best practices audit of the management practices and procedures. All of that has already been endorsed. It's already been approved. Uh, we've got draft documents for RFPs, and those will be circulated and in place in the very near future.

MR. MEDAFER: So what would the timeline be on that, uh, initiative? As far as after you've issued a contract, how long is the auditor expected to work?

MR. PIERCE: Yeah, Mr. Barnett, do you know,? Or Mr. McCall[phonetic] is here too on the investment side. Or Larry?

MR. GRISSOM: Uh, Mr. Medafer, I would estimate that once the auditor has been selected

for an audit as comprehensive as that, that their work would take probably on the, uh--on the high side of the year before their report is actually issued.

MR. MEDAFER: When I read--uh, the council voted on an item on November 18th, and reading in my own notes here, from what I've read in this, I wish I had voted no at the time. This was a letter from Ms. Schipioni to Mr. Ewell [phonetic] on 31 December, which still can curl your hair if you read some of the concerns that she has in this thing. Um, you know, I guess where I get to with this issue is that, as I've said, the last speaker used a word called confidence. And, you know, I certainly have confidence in the Retirement Board's interest in protecting the funds and moving forward. What I don't have confidence in is our ability to pay the shortfall. What I don't have confidence in is the fact that since the Mayor's Blue Ribbon Committee, you know, really came out with these issues, that, um, we're really done enough as a city to take this issue seriously. I'm very glad that it's on the agenda today, um. And I understand, Mr. Pierce, what you're saying with

respect to your--your audit committee. But I'm--maybe that's it. I'm thinking that, uh, you know, I'd really like to see a third party firm retained to review all of the details that we've seen today, uh, for an independent analysis. I would like to see that third party respond to the letters. I didn't even get in, because I don't want to take any more time here, I mean Ms. Folsom's letter, uh, she spoke and had some excellent points on concern about like the drop program right now. We're putting out money in the drop program that people are able to keep on account, earning interest on that, and that basically there's no limit as to how long they can keep that in there. And they're drawing interest at 8%, even though what's the return we're getting right now? And, you know, let's say it's 1%. How long does it take to make up the difference between what you're getting and the 8% that they're getting, and how is that affecting our ability to pay health benefits and all these other contingent liabilities, which are of a serious concern? And then, you know, she goes on. She has the health benefits, the fact that we have annual leave right now and how

that's being treated. There's a lot of people are able to convert annual leave to service in the system. Now, I don't know the latest report I saw--Mr. Manager, I'd be interested in seeing that again as part of the budget process. I think this city is going to have to be very diligent this time in looking as to how much time on the books we're going to allow employees to bank. Uh, this is a serious fiscal issue. The last time I talked to the auditor about it, two or three years ago, it was hundreds of millions of dollars that we owe employees.

MALE VOICE: Accrued over a long period of time.

MR. MEDAFER: Yes. But, you know, before, what was the year when they cut it off, before '92 or what have you, there was no limit as to the number of hours you could have on the books. I used to have an employee that worked for me who had something like four or five months on the books. And I know there's more that have--than have that. So, you know, I appreciate the comments as to the scare tactics. I don't think that that's a good way to play this thing. Let's take this from a serious standpoint, as it

really is, and, you know, fiscally prudent to get a clean, clear, and unbiased opinion. And if, Mr. Manager, I would like to ask, um, that you, um, review what it is that the audit people are going to be doing for the Retirement Board. I would like to ask, Mayor, that the Blue Ribbon Committee, uh, look at what the proposed--the RFP is for the, um, the audit that they're doing.

MALE VOICE: Yes, the Blue Ribbon Committee is really out of existence.

MR. MEDAFER: All right. What I'm trying to do, Your Honor, is I want to make sure--

MALE VOICE: Those people have all scattered.

MR. MEDAFER: I don't blame them.

MALE VOICE: The Chair is on the Airport Authority. The Vice-Chair is on the Ethics Commission. They're all busy doing other things.

MR. MEDAFER: Until I'd heard Mr. Pierce just speak with respect to the audit, that was exactly what I was going to request, is that we retain an independent third party to review what we've seen. I would like to see responses to

Ms. Folsom's letter. I would like to see responses to Ms. Schipioni's letter. I know we've seen them. I've seen Mr. Ewell's response. But I'd like to see a third party respond, with all due respect to the City Manager and the Retirement Board. I want to hear from an independent third party to make sure that we're okay, and most importantly, I want to hear the bottom line as to what it's going to cost San Diegans and what it's going to cost the city to make this system whole and to keep our employees, uh, feeling confident that they're going to get the money that they expect to get. Thank you.

MALE VOICE: Now, just following up on one thing, Mr. Medafer asked about, and that's the relationship between--I guess the right one is surplus undistributed earnings and contingent benefits. Um, it's not clear to me what you define as surplus undistributed earnings. Is that earnings in excess of 8%?

MR. GRISSOM: Okay, it is realized earnings, okay. Realized earnings is the sum of basically all cash income coming into the retirement system, dividends, pay-downs, and the net of

gains and losses on the sale of securities. That establishes what is called, in the muni code, undistributed earnings. Then it goes through--and we do have a lot of semantical problems with that. The muni code then establishes a priority order of things that will be paid from undistributed earnings. Whatever is left after those things have been paid, if anything, is surplus undistributed earnings, which, in accordance for the code, then gets redeposited or deposited or credited to the employer contribution reserve, one of our litany of, uh, reserve accounts for the purpose of reducing the system's unfunded liability, okay. So Mr. Medafer is correct in that, as you pay out of the earnings, uh, and if you will refer to, uh, the chart on page 24, you'll see that since the inception of these various benefits, that's totalled up in that left-hand column, $170 million, that's cash out of the system. That is money that has been spent, okay.

MALE VOICE: Okay, I understand your answer, but--and I read both your PowerPoint and your report, but it's hard to get my hands around at what point, uh, if we're using realized earnings

and undistributed realized earnings, on this priority list, at what point does, for example, health benefits, do we--can we pay into a health benefits reserve? Now, is there--I mean, there's got to be some point at which it becomes excess. In other words, if it's--if we only have realized earnings of 6%, I'm assuming there's--is there no surplus unrealized--undistributed realized earnings?

MR. GRISSOM: Um, I'd rather answer that with hard dollars rather than percent, because percentages get, uh, dangerous and, of course, they fluctuate with, uh, the assets and all of that. To pay everything that is listed in the priority order in the muni code takes between $110-120 million a year, okay. This is crediting employee and employer contribution accounts, paying our operating budgets. Then it starts down the 13th check, insurance, Corbett, and then the other two reserves.

MR. MEDAFER: [crosstalk] Your Honor, for interrupting. How much are we paying now?

MALE VOICE: Uh, for what, Mr. Medafer?

MR. MEDAFER: You say it takes 120 million. I'll ask the City Manager. What are we paying

in right now?

MALE VOICE: Uh, excuse me, Mr. Medafer. We're not--you're talking, if I'm understanding you correctly, about contribution income, and this is income from the investment program--two very separate things.

MR. MEDAFER: The question I'm trying to get at is at what point are there surplus undistributed realized earnings that go into the balance of our assets? When it's in excess of 120 [crosstalk]--

MR. GRISSOM: Anything over and above 110, 120 million dollars.

MR. MEDAFER: And that's the first time that we are--that we would be adding--let me go back--this was the chart on--well, the chart that shows what the total assets are and the total liabilities that comes out to 720. When we add to that total assets, you've got to have realized earnings in excess of 120 million before you add to that. No?

MR. GRISSOM: No.

MR. MEDAFER: Does that include the appreciation--

MR. GRISSOM: No, because the total assets

include all of the things that we're talking about.

MR. MEDAFER: It includes the appreciation in, for example, real estate holdings or--

MR. GRISSOM: Correct. On a total return basis, that includes appreciation, appreciation you do not necessarily realize until you sell the asset that has appreciated. So total return is the value of everything in the fund if you were able to sell it today.

MR. MEDAFER: Okay, but when we talk about the $720 million-deficit, okay, if the stock market were to tomorrow double, a lot of that-- our stock holdings tomorrow were to double, a lot of that deficit would go away.

MR. GRISSOM: Absolutely, absolutely.

MALE VOICE: Okay. All right, let's go on to, um, Mr. Peters.

MR. PETERS: Thank you, Your Honor. Um, the first thing I wanted to say was, uh, before we let it go, is that, um, I wanted to thank the Mayor for bringing this up in a public setting like this. It is not that long ago that a public discussion of something of this, um, seriousness would never--would be unheard of,

and I think we should not forget that. And I thank you for that. Uh, the second thing is I also want to acknowledge that, um, no one made any money in the last couple of years with the stock market, and the fact that you have done as well as you've done, in particular compared to other, um, entities of your type, is--deserves our, um, gratitude, the fact that you've, um, outperformed these other, um, funds, uh, the way that you have, I think is good for us. And I think that that's some good news. Obviously, we have a very serious problem we want to deal with, but, um, if we were performing like some of the other funds, uh, it could be--you know, it could be significantly worse. So I want to thank you for that. Um, just a note on the contingent benefits. I would just differ with Mr. Medafer, um, his characterization of being able to pay people what they expect, and I'm not sure if that's what he intended to convey. But, you know, obviously we have a legal obligation on these contingent benefits to pay what we're--what people are entitled to. Uh, I can't account for what people expect. But I do know that with respect to the 13th check, when we paid

it the last time, is that both sides were very clear that they understood that this was a contingent benefit, uh, and they wanted this one last payment of the check as a transition, sort of to let people down easy. And that was what I heard when we voted for that 13th check the last time. Um, I hope I'm not hearing something different today, which is that, um, we're supposed to come up with this 13th check out of something other than these surplus earnings, because we are not, in this city, in any position to snap our fingers and turn what are contractually contingent benefits into assumed and forever benefits. I just think that's an unrealistic, uh--that's unfair, but it's also an unrealistic, uh, portrayal of the city budget situation. We would be making this problem that much worse by doing that. And I suspect that's not what Mr. Medafer, uh, intended to convey, but I wanted to make sure that that was clear. We have to--we have the right--everyone has the right to expect what they have a right to, but if they expect more than that, um, I think, particularly in these economic times, it's going to be difficult.

MR. MEDAFER: If I may, Mr. Peters. You're absolutely correct. My concern is very clearly, though, in the area of the health benefit issues, which I see that as just going way out of control and little to cover that.

MR. PETERS: And I don't see those as contingent benefits at this [crosstalk], at this point.

MR. MEDAFER: No, no, they're not.

MR. PETERS: Um, then the other thing is, I understand that the county dealt with this just recently within the last year by some sort of bonding. Is that correct, and can you describe-- I mean, their ratio went way down also. How did they handle that?

MR. GRISSOM: Okay, a little bit of background on the county. Um, the county issued--and they're called pension obligation bonds--they issued, uh, one issue in 1994, which, uh, was in the amount of $432 million, if I remember correctly. Absolutely the best time in recorded history for them to have done that, but what that tells you is that their unfunded liability at that time was $432 million. Of course, in 1994 that came into the investment

program in the teeth of the bull market, and it raised their funding ratio to, in 2001, 107%. This year the, uh, county negotiated with its various labor organizations for a massive increase in benefits, remembering that we have increased benefits in some form or fashion, uh, both active members and retirees, once a year since about 1991, okay. The county had not done that. They did a massive, uh, benefits increase. The price tag on that, uh, in terms of liabilities was nearly $1.2 billion. That caused their funding ratio, on that basis, to drop from, uh, 107% to between 70 and 75%. They then issued, uh--

MR. PETERS: Ours is 77, so roughly--

MR. GRISSOM: Ours is 77, right. And they then issued a second issue of, uh, pension obligation bonds last fall, and I believe the number was in the vicinity of 700 million. They used part of the proceeds of that issue to pay off the remaining balance on the first issue of bonds and, uh, netted into, uh, the retirement system 550 million. Now, what that does--has done to their funded ratio contribution rates and that sort of thing at this point, I cannot

tell you because I don't know. But they basically bonded part of the new obligation.

MR. PETERS: All right. Well, this is going back to the City Manager, and I'm fine with that. I guess I'd like you to, um, consider, what other entities have done in response to what appears to be even worse problems than we have, um, as part of your evaluation, and would ask to have that back as part of your report. [crosstalk] I have one question on slide number, uh--well, I don't remember what slide was it. I think it was number 9. Just so I understand the role of this target rate of return. Um, you have this--this, um, guidepost of 8%. What role does that play in--I guess I'm just still not clear on what role that plays in setting your behavior.

MR. GRISSOM: Um, it does two things. One is that the target rate of return has an impact on the actuarial contribution rate. Simple way: if it's higher than 8%, the contribution rate will go down; if it's lower than 8%, the contribution rate will go up. The second thing that it does, in terms of the retirement system, the Board, through its investment committee,

goes through a process annually of looking at our asset allocation, and there are certain capital market assumptions. I won't get into all of the detail of that unless you want me to. But the investment program is structured to obtain a total return of 8% or whatever that assumption number is. Now, this again is a long term thing. If you look at, uh--

MR. PETERS: So that's--so just--so that's sort of a way for you also to manage how much risk you assign to the [crosstalk].

MR. GRISSOM: That's right, that's right.

MR. PETERS: Okay, I understand. All right, then I guess my final comment--um, this is somewhat off the mark, but maybe Mr. Azunza knows the answer. Is our President still recommending that my Social Security be put in the stock market? [laughter]

MALE VOICE: I did not vote for our current President.

MALE VOICE: And Ralph Nader appreciates your vote. [laughter]

MALE VOICE: All right, uh, Mr. Mainchen.

MR. MAINCHEN: Thank you, Your Honor. There have been, uh, a number of things that have come

before the council, that I felt like I, uh, was at an advantage on by being an attorney, but this is one of the ones where I think if I was a CPA or an actuary, I guess, uh, it would be a little bit easier. So my questions may be a little bit all over. Mr. Medafer and Mr. Peters asked some of them. But, um, all the projections that we've seen to date, um, do those include an 8% rate--a projected 8% rate of return in 03, 04, and onward?

MALE VOICE: Yes.

MR. MAINCHEN: Okay. Um, how much more, um, beyond I guess what we're calling Manager's Proposal Two, uh, would it cost the city to include contingent benefits and health insurance in the funding ratio?

MR. GRISSOM: I'm not sure, Mr. Mainchen, exactly how to answer that. To include the--all the contingent benefits and the insurance, as actuarially funded, would increase the liabilities by, uh, roughly a billion two. If we look at the breakdown of our--pardon me for talking out loud, but this is helping me think here. Uh, if we look at the breakdown of our current actuarial contribution rate, it's 21%.

The normal cost is 12. So that means that 9% of payroll amortizes 720. So to amortize a billion eight would be somewhere between 15 and 18%, I would say off the top of my head.

MR. MAINCHEN: Okay. What's the reasoning for not switching from the projected unit credit, um, funding method to what I think everybody would agree is the more conservative entry age normal method now rather than waiting until 2009?

MR. GRISSOM: Um, I guess the simplest answer to that is that this was part of the negotiations that took place between, uh, the city and the Board in the development of Manager's Proposal Two that we would not make that change to EAN until 2009.

MR. MAINCHEN: There's been some mention, and I know I've gotten a couple of letters on this, uh, about pension obligation bonds. Can you talk about what the advantages, disadvantages are to that?

MR. GRISSOM: Um, the advantages of pension obligation bonds are twofold. One, of course, is that it, uh, puts X number of dollars into the retirement system, which then reduces the

unfunded liability and reduces your ongoing contribution. The other is what is the industry term arbitrage. If you were able to write, uh, bonds, and the bond payment is at an interest rate less than the 8%, which is, uh, the calculation that, uh--the interest that we use, then quote, quote, you are money ahead. The disadvantage at the current time--we've talked a lot about investments--is that you could write pension obligation bonds for let's use the $720 million liability number. You're then separately obligated to pay off that bond. You provide that money to the retirement system, and given the volatility of the current markets, uh, in one year's period of time, we lose 10% and we lose 10% of that 720, so you now have a, uh--an unfunded liability all over again. That's the primary risk.

MALE VOICE: It's just borrowing money to pay debt essentially.

MALE VOICE: Okay.

MR. GRISSOM: Correct.

MR. MAINCHEN: Borrowing money to pay a credit card. All right. Um, how come the Corbett lawsuit isn't being included as, you

know, I guess a price benefit, since it--I'm assuming it must eventually be paid.

MR. GRISSOM: The answer to that gets a little technical. Corbett was litigation, and the Corbett benefit that we're talking about was a part of the settlement of that litigation. The settlement language very specifically says that the payment in any one year is contingent upon there being sufficient earnings to pay it. That makes it a contingent benefit legally. However, the second sentence in that portion of the settlement says, in any one year, when you do not have sufficient earnings, you will accrue the amount of that payment to the subsequent year, which means that that's ultimately going to be paid, which makes it a noncontingent benefit. We've discussed this back and forth. Uh, staff and the actuary recommended to the Board at one point that we include it as a part of the liability. The Board chose not to do that. Counsel advised them that, in terms of the settlement language, uh, they were, uh, basically correct in doing it either way.

MALE VOICE: If I may, I'd like to add just a little bit to that. Um, the Corbett lawsuit

came out of what was called the Ventura decision, uh, and it was Ventura County, and it had to do with, uh, benefits that employees thought they were eligible for. They were benefits above and beyond the base salary. So there was a series of negotiations to the lawsuit, and basically it was a compromise. And the compromise was that it didn't go fully to what the Ventura, uh, decision was, but at the same time provided enhanced benefits to employees in what I felt was a, uh, reasonable approach under the circumstances within that lawsuit. So it was a negotiated, uh, benefit, uh, as a result of allegations and concerns that, uh, the benefits should be higher as a consequence of what happened in another public jurisdiction.

MR. MAINCHEN: Okay. Um, I guess I'll wait and see. I have other questions, but I guess I'll wait and see what we get, um, when we get the manager's report. I would say this. It does give me great concern when I see city retirees coming down here being concerned about benefits they've earned, and that needs to be remedied because that's not right, and, uh,

there does need to be some confidence restored. Clearly, our city, like every other city, has taken a beating in the stock market and, you know, that's somewhat understandable. But, uh, I want to urge you in the strongest terms that you need to come back with a report that gives us options to make sure that we are restoring that confidence, so that our current retirees, who've put their time in, don't have to come down here and feel like they're arguing for their benefits, and then the current people who are working here have some confidence that those benefits are going to be there when they retire.

MALE VOICE: All right, I think what we need is a motion to refer this to the City Manager for a report back in 60 days as to what corrective action should be taken. I think Mr. Medafer wanted that response to include, um, an evaluation of the outside audit idea. Um, Mr. Peters wants that to have an analysis of the--Mr. Peters, you want the motion to include an analysis of the--I guess the pros and cons of bonding as well as who else has done it, and just some investigation of what other jurisdictions

who, um, are in our position. And then I would--

MR. PETERS: Are doing or are about to do.

MALE VOICE: On bonding.

MR. PETERS: On any--including bonding, but any other ideas we might be able to glean.

MALE VOICE: Okay, so the--it would include an analysis at least of what other major California cities, uh, are doing, uh. I think it would be interesting to include in that, uh, you know, for example, what's been their experience, or what's the unfunded liability of Oakland, for example, um? You know, has the stock market adversely affected them, and where are they at? I think it's important for us to see ourselves in the context of other major cities, perhaps limited to California, uh, because the markets are--or the stock market has, uh, affected cities, uh, equally in California. And then, I think finally I'd like to see, uh, a more detailed breakdown of the--how realized earnings are allocated. It's referred to generally in the report that you wrote, but it kind of refers you to the municipal code and says, well, it's pretty

complicated; see municipal code section XYZ to, uh, know exactly how it's done. I think we need to--we need to see how that all fits together in terms of--because I think that the issue here that is probably most troubling to me is the health benefit issue because, um, the deficit in the, uh, unfunded liability, while a concern and serious and not to be, uh, understated, nevertheless is caused primarily by the stock market crash. But, as Mr. Peters pointed out, we--this health benefit liability is, um, not exactly contingent. Um, maybe it's contingent for the retirement system, but it's not contingent for the city. And if the retirement system doesn't, um, account for this and provide adequate resources, uh, it's going to come out of the general fund or it's going to come out of the general fund plus the enterprise fund. So, I mean, I just think it's a serious issue. I'm not quite sure what the answer is.

MR. MEDAFER: Your Honor, I'd make that as a motion, uh, those items that you indicated, the audit, Mr. Peter's comments, your comments on breakdown. And just want to add to that that the Manager, as part of his report back, um,

give us--

MALE VOICE: I thought I was in the middle of a sentence, but that's okay. I thought you were making the motion, um. Go ahead, Mr. Medafer.

MR. MEDAFER: Your Honor--

MALE VOICE: Is there a second to his motion?

MR. MEDAFER: Adding your motion, and then I'll let you--

MALE VOICE: Well, why don't you finish your comment.

MR. MEDAFER: I'm just interested in having the Manager give us some fiscal options as well.

MALE VOICE: Um, and so my final point is I think that it's important to reiterate what, uh, Judy Italiano said, which is that, you know, no city employees' retirement benefits are--you know, are under any immediate threat of not getting paid, but we need to be, as stewards of the system, address the long term responsibilities as, uh, the people in charge of the city, to make sure that, as we look out 10 or 20 years, uh, we've addressed the problems now and didn't just sweep it under the rug like

apparently some prior councils did. So, uh, all in favor of the motion signify by saying "aye," opposed "nay." It passes unanimously. We'll take a five-minute break, and then we'll come back and do the last item on our agenda.

[END TRANSCRIPT]

SAN DIEGO CITY EMPLOYEES RETIREMENT SYSTEM:

REPORT ON THE MAYOR'S BLUE RIBBON COMMITTEE ON CITY FINANCES

Outline of Today's Meeting

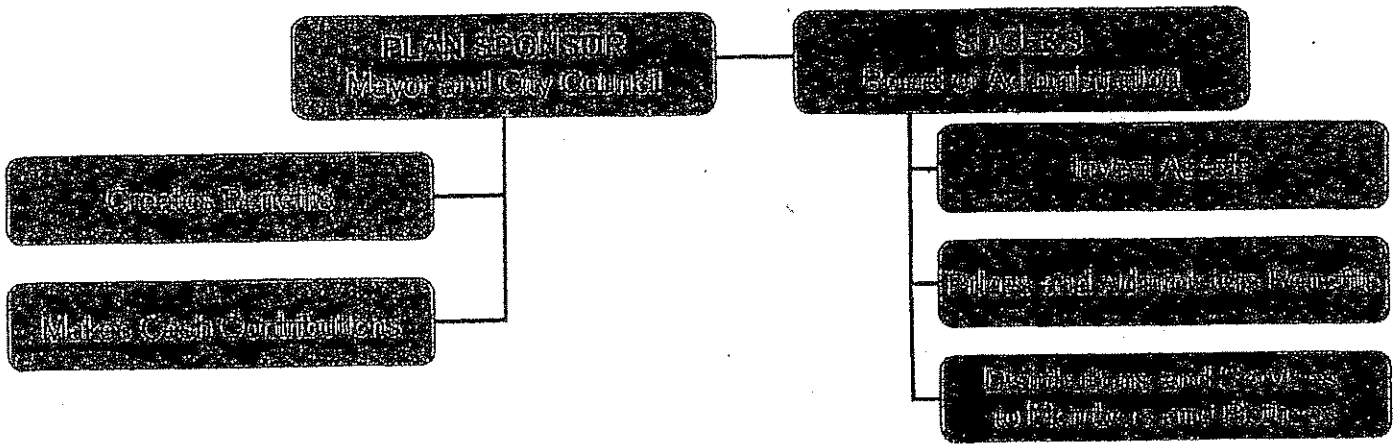
- Background of SDCERS
- Defining the Issues
- Historical Perspective and Contingent Benefits
- Looking into the Future
- Corridor Funding (the Manager's Proposals) and Health Insurance
- Funding Alternatives and Discussion

SDCERS: WHO WE ARE

- SDCERS is responsible for administering and managing the defined benefit retirement funds for the City of San Diego, the Unified Port District and the Airport Authority (the Plan Sponsors), and for their General Members, Safety Members, Elected Officers and Retirees.

- Roles and Responsibilities: the City Council, as the Plan Sponsor, establishes benefits and makes contributions to support benefits; SDCERS invests the assets to reduce future City contributions, administers the benefits and provides the cost of these benefits.

Roles and Responsibilities



SDCERS: WHO WE ARE

- The 13 Member Retirement Board is comprised of:
  - 3 representatives from the City (Manager, Auditor and Treasurer, or designees);
  - 4 citizens appointed by the City Council;
  - 3 representatives elected by General Members;
  - 2 representatives elected by police and fire safety members (one of each), and
  - 1 representative elected by retired members.

SDCERS: WHO WE ARE

- The Membership in the Fund as of June 30, 2002:

	City Plan	UPD Plan
Active General Employees	9,359	763
Active Safety Employees	3,323	188
Retirees	4,569	259
TOTAL	17,242	1,210

SDCERS: CURRENT STATUS

- The Investments of the Fund as of December 31, 2002:

Equities (51.0%)	$1,228,211,382
Fixed Income (38.7%)	$932,300,222
Real Estate (10.1%)	$243,665,393
Cash (0.2%)	$5,194,336
TOTAL MARKET VALUE	$2,409,371,333

SDCERS INVESTMENT PERFORMANCE

Despite difficult market conditions, the SDCERS Retirement Fund has performed in the top 15% of performance for Public Funds for the past one year, three years and five years:

Fund's 1,3 & 5 year Annualized Returns (as of 6/30/02)	-2.48%, +3.69%, & +6.97%
Average Public Fund's 1,3 & 5 year Annualized Returns (as of 6/30/02)	-5.15%, +0.52%, & +5.57%

SDCERS RETIREMENT TRUST FUND

Target Rate of Return (actuarial rate)	8%
Funding Ratio as of 6/30/02 (PUC Funding Method)	77.3%
Total Liabilities as of 6/30/02	$3.17 billion
Total Assets as of 6/30/02 (market value)	$2.53 billion
Total Assets as of 6/30/02 (actuarial value)	$2.45 billion
Unfunded Liability as of 6/30/02 (actuarial value)	$720 million

DEFINING THE ISSUES – WHY ARE WE HERE TODAY?

Responding to the Blue Ribbon Committee Report

- The Committee had two concerns:
  - Whether the City is paying out of its current year's budget the full cost being incurred by its current workforce for their future pension & retiree health benefits.
  - Whether the budgetary process adequately comprehends the steadily growing annual expense obligation, particularly given the uncontrollable & non-discretionary nature of this liability.

DEFINING THE ISSUES – WHY ARE WE HERE TODAY?

The Blue Ribbon Committee had two recommendations:

- Change the City's funding strategy to one that results in the City fully funding, on a current basis, its future obligations earned today which includes the pension benefits as well as health benefits.
- Obtain a current & comprehensive analysis of projected pension expenses & revenue sources, which includes the current present value of retiree health benefits to determine the impact on future City finances.

DEFINING THE ISSUES – WHY ARE WE HERE TODAY?

SDCERS summary analysis of the Blue Ribbon Committee's Report confirms the following:

1. The City is not paying out of current year's budget the full cost being incurred… for future pension & retiree health benefits.

2. There is a very significant growth in required annual pension cost which the City's budget must fund.

SDCERS: HISTORICAL PERSPECTIVE

As recently as two years ago, when the investment markets were very strong,

- The S&P 500's annualized return for 1, 3 and 5 fiscal years was +7.24%, +19.6% and +23.8%.

- The Retirement Fund was well funded with a funding ratio (ratio of assets to liabilities) of 97.3% as of 6/30/00.

SDCERS: HISTORICAL PERSPECTIVE

Over the last two years,

- The S&P 500 returned -14.83% in FY 2001 and -17.99% in FY 2002.
- The City settled the Corbett lawsuit resulting in an increased liability of $158 million plus an on-going contingent liability of approximately $5.5 million per year for retirees.
- Retirement Benefit Factors for General Members were increased from 2.0% to 2.25% on 7/1/00, and from 2.25% to 2.50% on 7/1/02. This equates to a 25% increase in the average pension for General Member retirees in two years.

SDCERS: HISTORICAL PERSPECTIVE

- The Plan benefited greatly (e.g. good funding ratio) as a result of the unprecedented investment market boom of the '90's.
- The Plan suffered from the "bubble burst" and sizeable losses in the investment markets of the last 3 years.
- However, over the long run the Plan's investment returns have **exceeded** the actuarial earnings assumption of 8%/yr (even including the losses of the recent past):
  - 10 year average annual returns through 6/1992 = 14.34%
  - 10 year average annual returns through 6/2002 = 9.26%

SDCERS CORRIDOR FUNDING: WHAT IS IT?

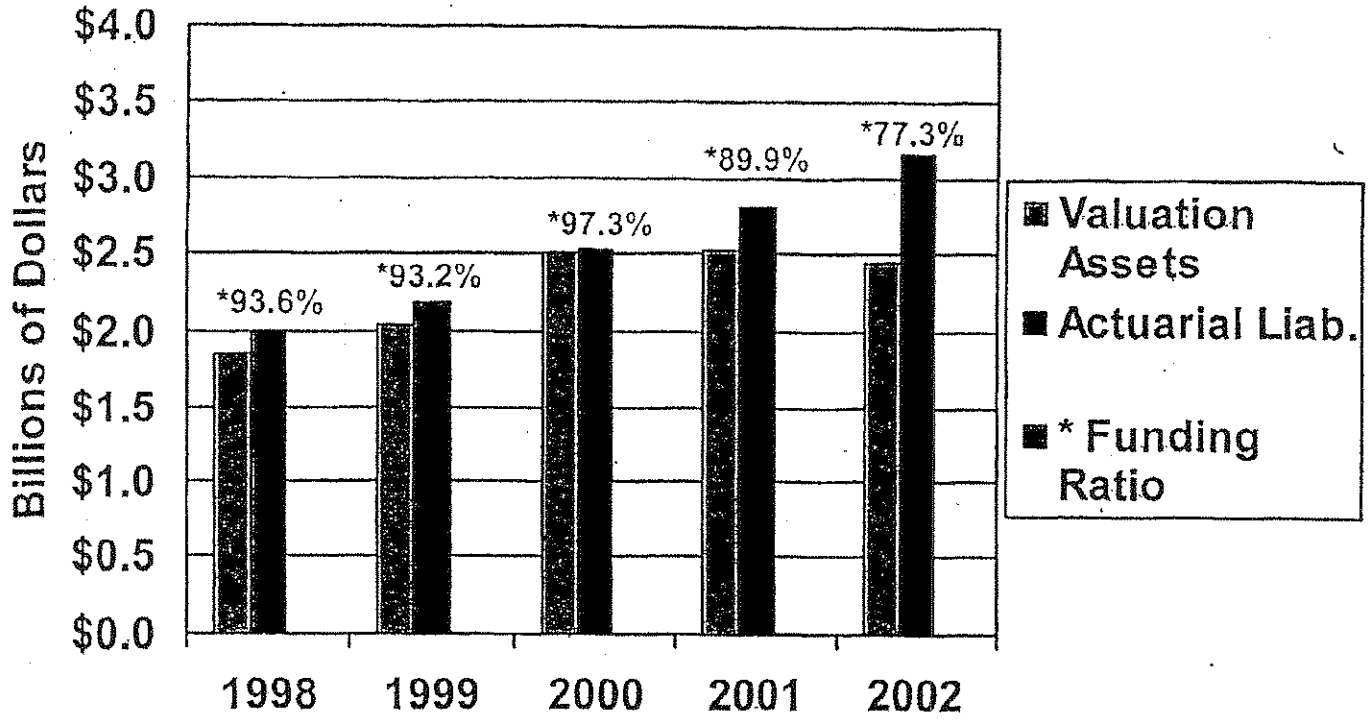
- In 1996, the City and the Retirement Board reached agreement on a proposal (the Manager's Proposal) to stabilize the City's annual employer contribution to the Fund. This Proposal allowed the City to contribute less than the actuarially computed contribution rate.

- Under the Manager's Proposal, the City's employer contribution rate increased 0.5% of payroll per year even though the actuarially computed rate increased more than 0.5% of payroll per year.

SDCERS CORRIDOR FUNDING: WHAT HAVE BEEN THE RESULTS?

- From 7/1/97 through 6/30/03, the difference between what was contributed by the City and what would have been contributed under the amounts computed by the actuary, plus earnings on the difference, results in a funding shortfall of approximately $102 million.
- New Manager's Proposal II has been approved by the City, the Retirement Board and Members which requires the City to "ramp up" its employer contributions each year until it achieves the actuarially computed PUC funding rate by 2009.

FUNDING HISTORY

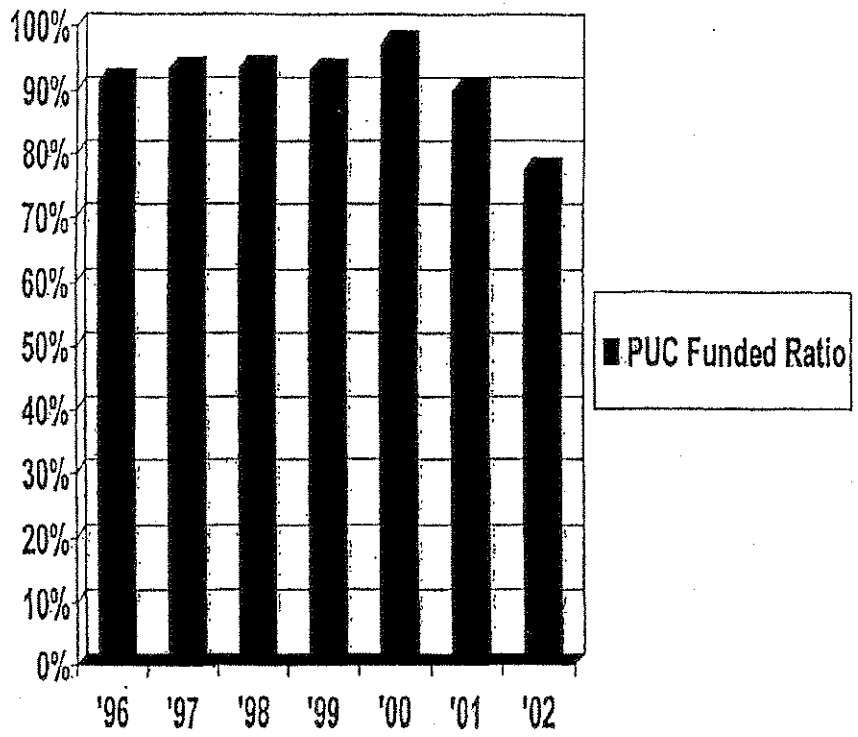


FUNDING HISTORY

Fiscal Year End (June 30)	City Employer Contribution Rate	Actuarial Contribution Rate	Contribution Shortfall (in millions)
1998	7.83%	10.87%	$11.1
1999	8.33%	10.86%	$ 9.7
2000	8.83%	11.48%	$10.6
2001	9.33%	11.96%	$11.2
2002	9.83%	12.58%	$12.3
2003	10.33%	15.59%	$25.3
TOTAL	**CUMULATIVE**	**IMPACT =**	**$80.2**
TOTAL	**COMPOUNDED**	**IMPACT (8%) =**	**$102.1**

PUC FUNDING RATIO
(ratio of assets to liabilities)

FY Year End	Funded Ratio
1996	91.4%
1997	93.3%
1998	93.6%
1999	93.2%
2000	97.3%
2001	89.9%
2002	77.3%



SDCERS: CONTINGENT BENEFITS

- Contingent Benefits are benefits which are only paid each year if the Fund generates "excess" realized earnings. There is a hierarchy defined in the Municipal Code for paying these benefits until all of the "excess" realized earnings are paid out in a given year.
- The Contingent Benefits of the Fund, in the order prescribed by the Municipal Code, include:
  - the Reserve for Retiree Health Insurance;
  - the 13th check;
  - the Corbett Payment;
  - crediting of the Supplemental COLA reserve;
  - crediting of the Employee Contribution reserve

SDCERS: REALIZED EARNINGS

- In the "up" market of recent years, the Retirement Fund's realized earnings were strong, reserves were high and all Contingent Benefits were paid.
- The trend has changed. Realized earnings as of 6/30/02 were $51.2 million, insufficient to pay all Contingent Benefits.

Year	Realized Earnings	All Contingent Benefits paid
1999	$189.3 Mil	Yes
2000	$415.9 Mil	Yes
2001	$168.0 Mil	Yes
2002	$51.2 Mil	No
2003 (as of 11/30/02)	- $55.5 Mil	Unlikely

SDCERS: CONTINGENT BENEFITS

Contingent Benefit	Paid Since	Avg. Total Annual Cost	Number of retirees receiving payment
Health Insurance	1982	$10 million	3,543
13th Check	1980	$3.8 million	4,695
Corbett	2000	$5.5 million	4,267

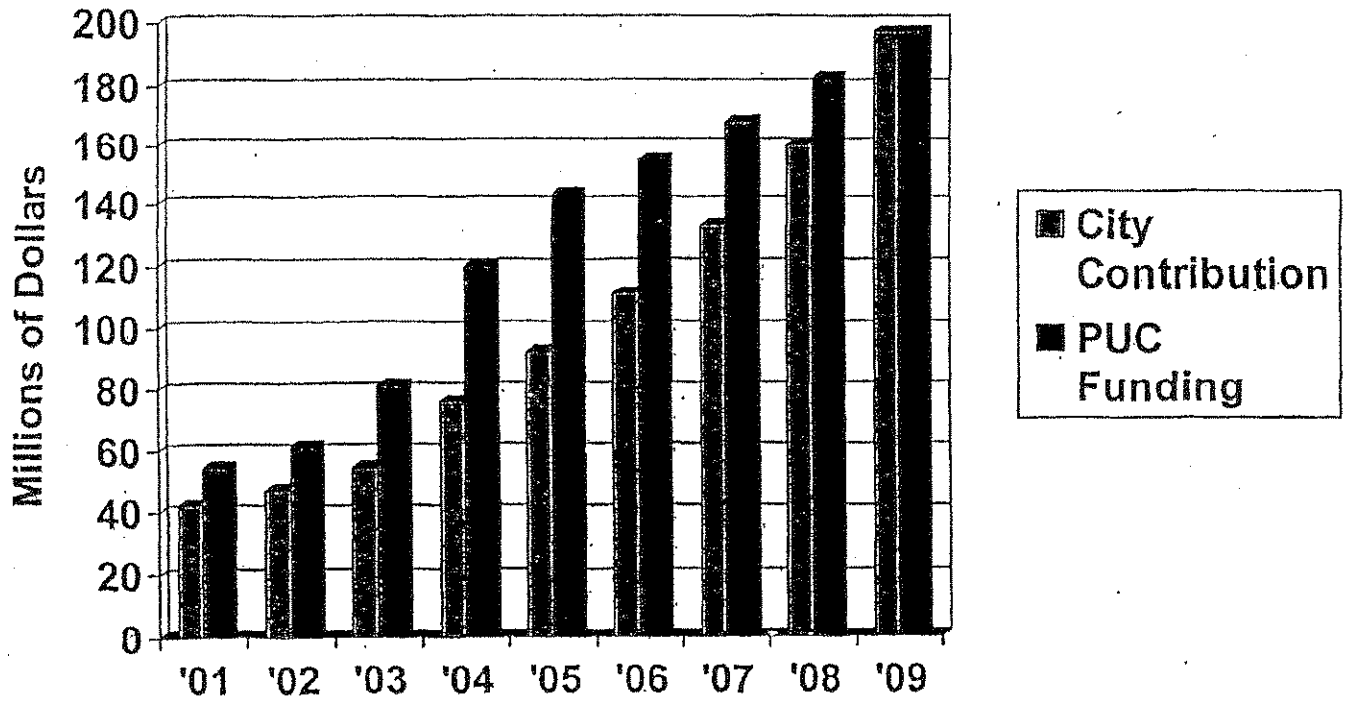
PROJECTIONS OF CONTINGENT BENEFITS COST AND LIABILITIES

Contingent Benefit	Amt Pd from inception to 6/30/02	Total Amount of last annual Payment	Projected Payment FY '03	Projected Liabilities (Present Value in Today's Dollars)
Health Insurance	$56.8 million	$9.5 million	$10 million	$1.1 Billion
13th Check	$58.0 million	$3.8 million	Not paid	$58 million
Corbett	$28.9 million	$5.6 million	Not paid	$75 million
Employee Cont Rate Reserve	$15.3 million	$3.2 million	Not Paid	$0
Sub COLA Reserve	$11.0 million	$2.8 million	Not Paid	$0
TOTAL	**$170.0 million**	**$24.9 million**	**$10 million**	**$1.23 Billion**

PROJECTIONS INTO THE FUTURE

- This year's City Employer Contribution was $54 million, or 10.33% of payroll (the City also paid another $28 million on behalf of employees' required contribution – the Offset).
- By 2009, assuming covered payroll increases by 4.25% per year, the actuarial contribution rate increases 3% next year due to increased benefits, and 1% per year thereafter, the City's payment in 2009 would be $197 million (this does not include the amount of any City offset payments towards employee contributions).
- If Contingent Benefits are also paid by the City in 2009, assuming no "excess" earnings in the intervening years, the contribution would have to increase by another $57 million to $254 million.

THE CONTRIBUTION SHORTFALL

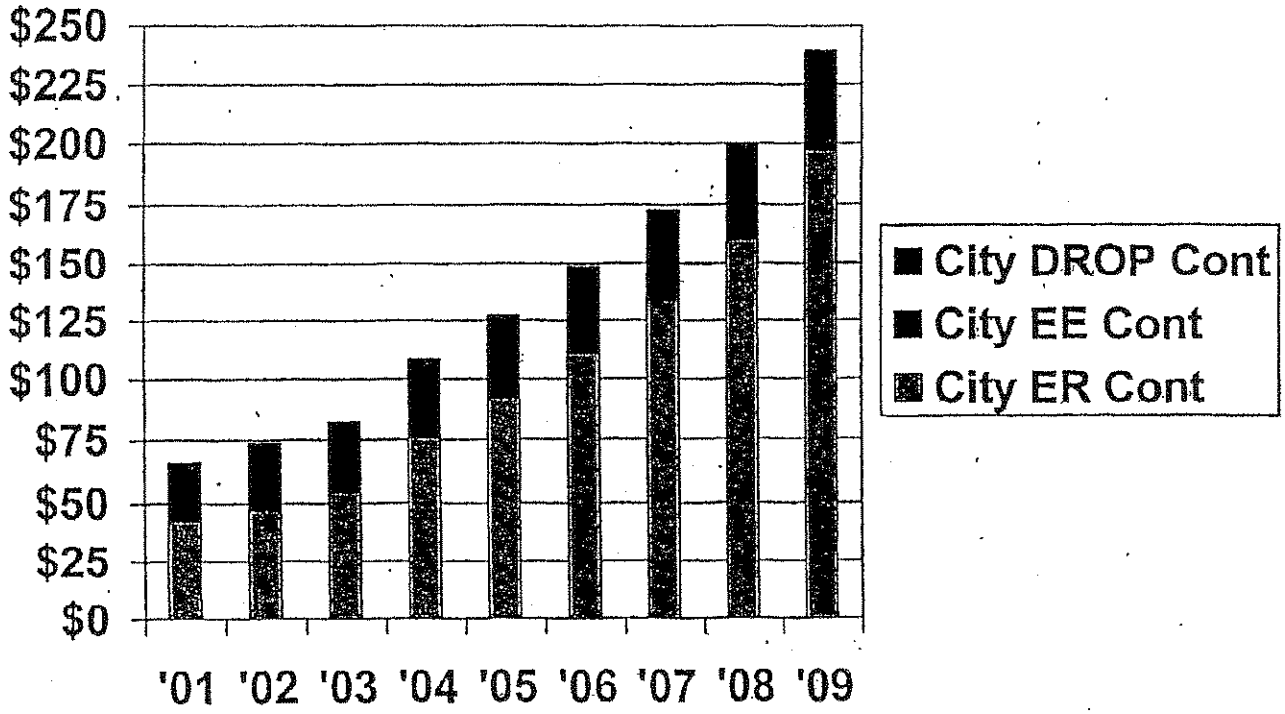


A PROJECTED FUNDING FUTURE

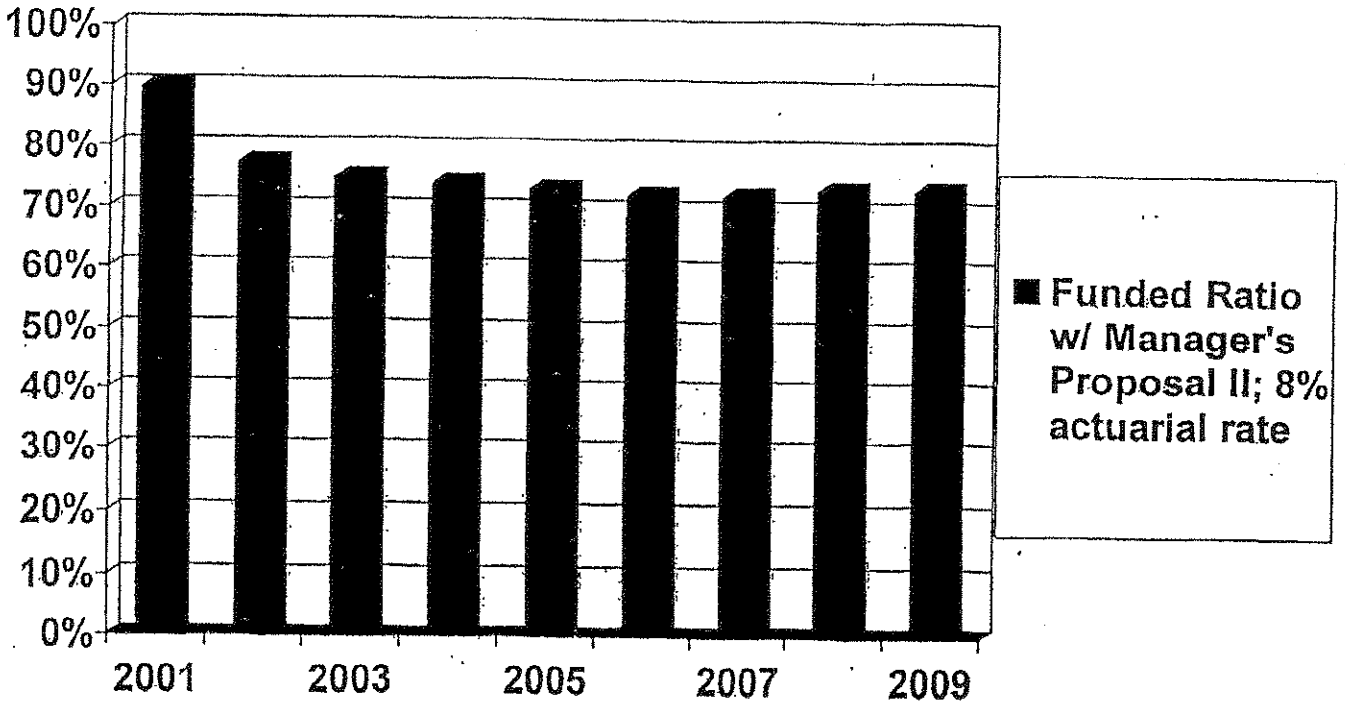
Year	City Employer Contribution	City Employee Contribution	City DROP Contribution	Total Contribution
2001	$42 million	$23 million	$1.0 million	$66.0 million
2002	$47 million	$26 million	$1.1 million	$74.1 million
2003	$54 million	$28 million	$1.2 million	$83.2 million
2004	$76 million	$31 million	$1.3 million	$108.3 million
2005	$92 million	$34 million	$1.4 million	$127.4 million
2006	$111 million	$36 million**	$1.4 million	$148.4 million
2007	$133 million	$38 million**	$1.5 million	$172.5 million
2008	$160 million	$39 million**	$1.6 million	$200.6 million
2009	$197 million	$41 million**	$1.6 million	$239.6 million

**assumes Employee Rate Reserve is depleted and Offset contributions not made by the City.

FUNDING PROJECTIONS



PROJECTED PUC FUNDING RATIO
(ratio of assets to liabilities)



2/6/2003

SDCERS: HEALTH INSURANCE TODAY

- Current benefits provide for payment of the premiums for eligible retirees' health insurance from SDCERS' "surplus earnings".
- Two Health Insurance reserves within the Retirement Fund will cover the payment of premiums for approximately 2 to 3 years.
- After these reserves are depleted, the City is obligated to pay from other funds (current cost is approximately $10million per year).

SDCERS: HEALTH INSURANCE IN THE FUTURE

- The actuarial liability of the City's retiree health insurance commitment is not required to be actuarially funded. Therefore, it is not included in the calculation of the City's contribution to the Retirement Fund.
- The City, through the Retirement Fund, is only paying health insurance premiums for current retirees – no contributions are being made for the future health insurance liability of today's employees. Thus future taxpayers may have to pay for prior year's expense which will become a significant annual cost.

MAXIMUM PROJECTED LIABILITIES OF PENSION, CONTINGENT AND HEALTH

Unfunded Pension Liability (6/30/02)	$720 million
13th Check and Retiree Health Insurance	$433 million
Future Retiree Health Insurance	$750 million
Corbett Contingent Benefit	$75 million
TOTAL	$1.978 Billion

SDCERS:
ANALYSIS OF ALTERNATIVES

1. Maintain Status Quo: City's annual cost will increase approximately 16% to 18% each year until 2009. Thereafter, increases will continue to grow in order to shift from PUC to EAN funding.
2. Issue Pension Obligation Bonds with the objective of reducing the unfunded liability.
3. Increase the Contribution Rate now to improve future actuarial funding.
4. Do both #2 and #3 to achieve full funding.

EXHIBIT 43

INTERIM REPORT NO. 2

REGARDING POSSIBLE ABUSE,

ILLEGAL ACTS OR FRAUD BY

CITY OF SAN DIEGO OFFICIALS

REPORT OF THE

SAN DIEGO CITY ATTORNEY

MICHAEL J. AGUIRRE

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9 FEBRUARY 2005

I.

INTRODUCTION

The San Diego City Attorney is issuing this Interim Report Number 2 related to possible Abuse, Illegal Acts, or Fraud by City of San Diego Officials.

In recent months, City officials have engaged in a series of acts and practices that have caused a delay in the issuance of a certification by KPMG, the City's outside auditor, for the City's 2003 financial statement.

During October 2004, KPMG requested that the City launch an independent investigation of potential illegal acts by City officials that led to the City's failure to discharge its financial disclosure obligations. Specifically, KPMG has requested a report supported by a thorough investigation and including clear conclusions about whether any relevant laws have been violated and whether individual conduct may have been fraudulent or unlawful. The purpose of the requested report was to provide a basis for determining KPMG's ability to rely on management representations from the City. The City Attorney has undertaken that task.

The City Attorney's First Interim Report reached the following conclusion:

> Despite the substantial financial crisis faced by the City due to funding problems in the City pension plan the Mayor's Blue Ribbon Committee Report on City of San Diego Finances represented the funding ratio was 97%. Thus, the Mayor's Blue Ribbon Committee Report on City of San Diego Finances contained a material false statement that the San Diego City Pension Plan's funding ratio was 97% when in fact it was 89.9% funded as of 30 June 2001. The report also

failed to disclose that by 11 October 2001 the audit staff of the City had determined that the investment portfolio of the City's pension plan had dropped significantly. Finally, the possible triggering of the City's duty to make a sizeable balloon payment to the plan was not mentioned. City officials allowed this misinformation to be perpetuated despite various opportunities to correct the record. Thus, taxpayers and other users of the Mayor's Blue Ribbon Committee Report on City of San Diego Finances were misinformed about material financial information regarding City finances.

The failure to include accurate information about the dire financial condition of the City's employee pension plan in the Mayor's Blue Ribbon Committee Report on City of San Diego Finances used in February 2002 raises serious questions of misconduct by City officials. The City Attorney's office is now conducting an investigation to identify the parties responsible for putting the false material statement in the Mayor's Blue Ribbon Committee Report on City of San Diego Finances and allowing this misinformation and/or omitted facts to be disseminated to the Council, the market and the public.

Had the public known that the City faced the very real prospect of having to pay hundreds of millions of dollars into the pension plan in order to meet its contractual duties under the MP1 agreement, would the City have proceeded with its decision to increase employee pension benefits by hundreds of millions of dollars? Had this information been disclosed would the City have continued to sell municipal bonds that did not make needed disclosures about the City's pension funding problems? Had this information been disclosed would the City be facing investigation by the SEC, FBI and US Attorney?[1]

On 11 October 2001, Assistant City Auditor Terri Webster understood that the City of San Diego faced a probable pension funding crisis. As the City's "chief fiscal officer," the auditor had a duty each month to know of and to keep the City Council

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[1] Interim Report No. 1 Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees, pp. 15-16.

informed about "the exact financial condition of the City and of each Department, Division and office thereof."[2]

By 11 October 2001, Assistant City Auditor Webster had learned of a significant drop in the pension fund earnings for the first two months of fiscal year 2002. She knew that during July and August 2001, pension plan earnings had dropped 71% from the same period fiscal year 2001. Because the losses pushed the City toward having to make balloon payments of several hundred million dollars, this development was ominous.

Ms. Webster's understandable emotional response to this development was captured in an email exchange with City of San Diego Human Resources Director Cathy Lexin entitled "EEEK":

> From: Cathy Lexin
> To: Webster, Terri
> Date 10/11/01 10:13AM
> Subject Re: EEEK
>
> FYI

---

[2] San Diego City Charter Article V §39. (Exhibit 1)

> YTD CERS [City Employees Retirement System] earnings as of August 31, 2001 in the CERS Trust fund is about $15m compared to $53M same time 2000...a 71% drop! BEFORE 9-11-01! It will be tight to even meet the base undistributed earnings distributions for FY 02 (ie. 13th check, corbett, etc).[3]

In 1996, the City and the pension board entered into an agreement that allowed the City to avoid its duty to make actuarially determined contributions to the pension plan. The decision to relieve the City from its duty to provide full actuarial funding resulted in a decrease of the pension plan's funding ratio. The pension plan's funding level fell from 97.3% as of 30 June 2000; to 89.9% as of 30 June 2001.[4] In fiscal year 2002 it fell to 77.3% , in fiscal year 2003 to 67.2%, and in fiscal year 2004 to 65.8%.[5]

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[3] 11 October 2001 (10:13 AM) Email from Cathy Lexin to Terri Webster on the subject of "EEEK." (Exhibit 47)

[4] 14 June 2002 Memorandum from Cathy Lexin to Mayor and City Council p. 2. (Exhibit 2)

[5] San Diego City Employees Retirement System Annual Actuarial Valuations 30 June 2003 p. 13 (Exhibit 3) and 30 June 2004 p. 13 (Exhibit 4); see 14 June 2002 Memorandum from Cathy Lexin to Mayor and City Council p. 2 (Exhibit

2).

Under the terms of the 1996 funding agreement, and in view of the funding ratio dropping to 77% in fiscal year 2002, the City faced the prospect of having to contribute $159 million to the pension plan in order to restore its funding level to 82.3%. Clearly the growing problem with the pension plan's funding ratio created a financial crisis for the City.[6] The Mayor and Council would have to find hundreds of millions of dollars in a budget that was already strained. On 30 June 2003, the funding ratio decreased to 67.2% from the 30 June 2002 level of 77.3%.[7] The descending funding ratio would have required the City to pay the $159 million in 2004 and

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[6] The "funding ratio" refers to the ratio between the pension's assets and liabilities.

[7] 23 July 1996 Memorandum from Cathy Lexin to Larry Grissom re: City Manager's Retirement Proposal, p. 7 (Exhibit 5); see also, 30 June 1996 Actuarial Valuation (Exhibit 6).

another $371 million in 2005.[8]

[8] Under the trigger, the City was required to return the pension plan to a 82.3% funding ratio by the July following the applicable actuarial report. The funding ratio fell to 77.3% (5% below the 82.3% trigger) as of June 2002 and 67% (15% below the 82.3% trigger) as of June 2003. Under the trigger formula, the City was required to pay $159 million by 1 July 2004 (.05 x $3,168,921) and $371 million by 1 July 2005 (.15 x $3,532,626); see, 23 July 1996 Memorandum from Cathy Lexin to Larry Grissom re: City Manager's Retirement Proposal, p. 7 for trigger formula. (Exhibit 5)

This 1996 agreement violated the Charter provision requiring the City to fully fund the pension plan.[9] The plan's fiduciary counsel permitted the 1996 agreement, which provided for the City to underfund its pension, only on the proviso that if the funding ratio fell below 82.3%, the City would pay the amount needed to restore the funding level to 82.3%:

> The basis for the prior fiduciary counsel condoning the original agreement to accept less than full actuarial contributions from the City, was the establishment of a reasonable funding ratio floor (82.3%), and the expectation of progress toward full funding pursuant to this plan.[10]

II.

THE SCHEME TO AVOID THE TRIGGER AND BALLOON PAYMENT

A. TRIGGER AND BALLOON PROBLEM DISCOVERED

The agreement requiring the City to keep the employee pension plan at or above 82.3% was set forth in a 23 July 1996 memorandum from City Labor Relations Manager Cathy Lexin to pension plan administrator Larry Grissom:

---

[9] San Diego City Charter Article IX § 143 (Exhibit 7); See, San Diego Municipal Code § 24.0801 (ante November 2002) (Exhibit 8).

[10] 14 June 2002 Memorandum from Cathy Lexin to Mayor and City Council p. 2. (Exhibit 2)

> The City will pay the agreed-to rates shown above for FY 96 through FY 2007. In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation which will include the impact of the benefit improvements included in this Proposal, the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City-paid rate will be the amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation.[11]

The Council and Mayor, City Auditors Ed Ryan and Terri Webster, City Treasurer Mary Vattimo, pension plan administrator Lawrence Grissom, pension plan board member and Blue Ribbon Committee member Richard Vortmann, pension board Chairman Fred Pierce, and other City and pension officials watched with consternation as the pension plan's financial condition deteriorated throughout fiscal year 2002. Together these officials decided not only to keep the people of San Diego in the dark about the situation, but also to withhold the adverse financial facts from investors in the City's bonds. As the pension plan's funding ratio plummeted towards the trigger, the concerns of these financial insiders grew.

On 3 December 2001, in an email she titled "earnings EEEK!" and signed

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[11] 23 July 1996 Memorandum from Cathy Lexin to Larry Grissom p. 7 (Exhibit 5); the 1996 actuarial valuation was 92.3% (See, Annual Actuarial Valuation as of June 30, 1996 p. 16 (Exhibit 6)).

"Sleepless in San Diego," Assistant City Auditor Webster wrote pension administrator Lawrence Grissom about the further deterioration of the City's investment earnings:

> Larry
> Oct statements showed $15.4 m loss on sale of stocks and a total monthly loss of $7m bringing YTD earnings at Oct 31, 2001 to only $14.1 million compared to $107 m last year same time. A 87% decrease !EEEK!
>
> ***
>
> Sincerely,
> Sleepless in San Diego[12] [emphasis added]

One month later, on 3 January 2002, Ms. Webster, Auditor Ed Ryan, and Human Resources Director Cathy Lexin exchanged more bad news about and made contingency plans in response to the precipitous drop in the pension plan's earnings:

> Ed
> CERS fund earnings as of 11-30-01 was $17.4 million compared to $112.6 at 11-30-00 (85% decrease). {Oct was a 87% decrease so slight movement in the right direction occurred.}
>
> In order to fund the basic items listed in the Muni Code out of earnings using FY 01 numbers .... $118 is needed.
>
> ***
> Anyway ..... these are SERIOUS consequences and needs attention ....
> ***

---

[12] 3 December 2001 email from Terri Webster to Lawrence Grissom with a copy to Cathy Lexin on the subject of "earnings EEEK!" (Exhibit 9)

Terri [13]

One month later, on 12 February 2002, Terri Webster wrote Auditor Ed Ryan about the full gravity of the financial disaster enveloping the pension plan. As documented in the most recent actuarial report, there was a swing of $486 million against the City:

> Per Larry the actuary report shows a $200M loss....that's a $486m swing from the last report. Funding ratio drops to 90% from 97%...this assumes the $100m set aside for meet and confer is in assets. The trigger point is 82%. ...
>
> Ugly Ugly [emphasis added]
> They project a $60m shortfall for FY 02 earnings.[14]

---

[13] 3 January 2002 emails between Cathy Lexin and Terri Webster. (Exhibit 10)

[14] 12 February 2002 Email from Terri Webster to Ed Ryan on the subject of EGF and CERS. (Exhibit 11)

On 12 February 2002, the actuarial report that Ms. Webster referred to in her email to Mr. Ed Ryan was released to pension board members. It showed that the funded ratio of assets to liabilities had dropped to 89.9% and that the unfunded actuarial accrued liability had grown from $68,959,000 to $283,893,000, a 290% increase.[15] On 28 February 2002, in light of the further slide of the funding ratio, auditors Ed Ryan and Terri Webster had a discussion with City officials involved in the employment negotiations with the unions representing City workers. The topic of this discussion was the need to include the effect of the trigger on the meet and confer labor negotiations.

> 2/289/2002 8:10 AM
> Email from Mary Vattimo to Ed Ryan, Terri Webster and Cathy Lexin
> (cc to Bruce Herring)
> Re: CERS earnings
>
> I think that discussing with Ron is good advice; he has indicated he doesn't understand what the big deal is.
> Mary
>
> >>>Ed Ryan 02/28/2002 7:54:16 am>>>
> Cathy, Bruce You might want to use Ron Saathoff to get their attention. I don't believe you can conclude meet and confer without knowing what retirement is going to do. That means they have to tell the City likely by the March meeting. [emphasis added] I believe the Manager has to tell Council the budget status before meet and confer concludes and he'd have to know the retirement solution to do that.

---

[15] San Diego City Employees' Retirement System Annual Actuarial Valuation 30 June 2001 p. 13. (Exhibit 12)

>>>Terri Webster 02/27/02 04:40 PM>>>
OH BOY....the CERS earnings for Jan is negative ($1.7)...we're moving in the wrong direction! So thru Jan 02 we're at $25 million compared to $146m last year almost 6 times worse than last year...

I spoke to Fred and still don't think he gets the point that we need answers now...and not just for a $60m shortfall but scenarios to cover a $70m and $80m shortfall.

Remember the FY 01 funding ratio dropped significantly when earnings were $165M. So at $40-60m it will be ugly.
Terri [16]

During this period auditor Webster explained in detail to a member of the pension board why the earning losses created a "fiscal time bomb" for the City:

I think your questions centered around why does the City care about the solution to the FY 02 earnings problem?

1. Funding Ratio: Fiscal time bomb is attached to this. [emphasis added] If it drops below 82.3% the City has to pay an additional/approx $26m a year.

Solutions that do not impact the funding ratio are the best. We need to know what the impact to the ratio is for the earnings solution...as well as I asked for the projected ratio based on FY 02 earnings.

The funding ratio is dropping rapidly in the present and last 2 year's investment market. If it dropped from 97.3% to 89.9% in one year and FY 02 are 1/5 of the FY 01 earnings....then it is likely to drop real close to the 82.3% trigger. Therefore anything that negatively impacts the ratio needs to be known ASAP.

---

[16] 28 February 2002 (8:10 AM) Email from Mary Vattimo to Ed Ryan, Terri Webster, Cathy Lexin, copied to Bruce Herring on the subject of CERS earnings.

2. Rating Agency impacts:

The Funding Ratio is a fiscal indicator of the health of the CERS fund which is a major fund of the City. A large drop in funding ratio or dropping below certain benchmarks could result in a negative impact to the City's credit rating. The City has a high credit rating which is vital to keep borrowing costs down for future issuances on the horizon such as for fire stations, main library, and branch libraries, etc.

3. Plan for more declines and Preserve every basis point of the ratio: this is essential now since the impact of the bad market is far from over....the actuary lags a year...so we probably have at least 2 very more lean years ahead.
Don't use assets unless absolutely have to.

4. Meet and Confer: is going on now...answers are needed from retirement now as compensation offers are being exchanged and the Mayor, Council and City Manager need to know what the current and projected CERS status is as they consider possible retirement enhancements.
Terri[17]

On 6 March 2002 and 7 March 2002, Ms. Webster and plan administrator Larry Grissom were exchanging the latest information on the erosion of the pension plan earnings and discussing whether the plan would reach the balloon payment trigger:

Lawrence Grissom 03/06/02 5:32PM

Hi Terri

*** Preliminary recommendation from staff (lucky me) is that ----

---

[17] 18 March 2002 Email from Terri Webster to Rgarnica@unitedcalbank.com on the subject of CERS. (Exhibit 13)

earnings still look to be in the $50 to $60 million range. ***
***
New benefits are a question mark. We are so close to the line on funding ratio, that Rick [Roeder] or I cannot predict until labor relations gives us something specific. If they go the general member increase and increase the offset, my best guess is that with a flat investment environment ie no gains, no losses, we will be around 83%.
Gonna get ugly [emphasis added]

Larry
CC: Cathy Lexin; Ed Ryan[18]

On 15 April 2002, the magnitude of the pension plan's staggering losses became clear to Assistant Auditor Webster and pension administrator Grissom:

Lawrence Grissom 04/15/02 3:24PM
Terri
Please treat this as confidential for the moment.....haven't shared with any of the other Board members—yet.
***
* I hope I'm wrong, but projections of the value of assets lead me to believe that actuarial losses on investments could be nearly twice as much this year over last year. That could be a reduction in the funding ratio of 7%, if all else is equal. Those two things, without any other actuarial losses or additions to liabilities for new benefits, etc. put us at about 80%. Not a happy situation [emphasis added]

***
Like I said, don't shoot the messenger.[19]

Ms. Webster responded to Grissom, reminding him that the funding ratio was

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[18] 6 March 2002 (5:32PM) Email from Lawrence Grissom to Terri Webster. (Exhibit 14)

[19] 15 April 2002 (3:24 PM) Email from Lawrence Grissom to Terri Webster. (Exhibit 15)

really 89% not 89.9%:

> From: Terri Webster
> To: Lawrence Grissom
> Date: 4/15/02 5:58 PM
> Subject: Re: Don't shoot the messenger — !!
>
> ***also awaiting actuary answers like how exactly calculate the $95.6 loss...also I think the 89.9% in [sic] around 89% since it appears the actuary counted all of the 105M reserve as since versus just the 100M....[20]

The avalanche of negative financial reports overwhelmed pension board and City officials. On 26 April 2002, auditor Webster admonished Human Resources Coordinator Cathy Lexin not to discuss the funded ratio until they both could get their stories straight:

> From: Terri Webster
> To: Cathy Lexin
> Subject: funding ratio
> Cathy
>
> I recall you mentioning that Larry said we'll be at a 84-86% funding ratio at 6-30-02. That makes no sense! I recommend not mentioning that especially on Monday since we're getting different stories. I have an email from Larry, less than two weeks ago which projected it to be at 85% on 6-30-02...the big drop (7%?) Will be due to FY 02 poor investment growth as well as a 1-2% loss due to the FY02 earnings solution.....so it makes no sense to me to now hear 84%. (Also we're at 89% no 89.9% since the actuary mistakenly gave us credit for $5.8 million of port money.) [emphasis added] [21]

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[20] 15 April 2002 (5:58 PM) Email from Terri Webster to Lawrence Grissom. (Exhibit 15)

[21] 26 April 2002 Email from Terri Webster to Cathy Lexin about the

subject of "funding ratio." (Exhibit 16)

B. CITY STAFF FIGHTS OVER THEIR OWN BENEFITS

By 17 May 2002, pension and City officials were fighting among themselves over their own benefits. The issue that sparked the internal bickering revolved around the lifting of the 90% cap for certain employees including Assistant Auditor Webster:

> Terri Webster 5/17 5:25 PM
> Why is this still out there? The maker of the "deal" Cathy/Dan, clearly clarified that DRAFT language is not binding and if there is a better way to do implement a 90% cap and the 2.5 at 55 that meets the City, union, members, and CERS needs...then Fine, we're not stuck with the old language.
> I thought we were now all working on the same project of fine tuning that solution...hence "Paul and Holly's" versions that just need some tweaking on Monday...we're almost there....
> Again...<u>why is Cathy's intent still being questioned</u> and desires to move backwards are expressed? [emphasis added]
> Terri[22]

Three days later, on 20 May 2002, Mr. Grissom lashed out at Ms. Webster and other City officials for "further attempting to 'pad'" their own benefits:

> Terri
> ***
> If, after being accused of violating everything and further <u>attempting to 'pad' your own benefits</u>, you guys feel you get another bite at the apple, go for it. I did not read Cathy as being at all amenable to changing the basic concept. If she did, then great! I honestly don't care how we do it, so long as everyone is on the same page. No desire to move backward on my part. You can't move backward until you've gotten somewhere in

---

[22] 17 May 2002 (5:25 PM) from Terri Webster to Lawrence Webster on the subject of the "deal." (Exhibit 17)

the first place. [emphasis added]
Larry[23]

Auditor Webster shot back at Grissom, defending herself and arguing that she did not get any "better benefit" and that the "statement 'pad your own benefits' is wrong."

5/20/2002 (10:26 AM)
From: Terri Webster
To: Lawrence Grissom
Subject: Re: Curmudgeon speaks

For the record, to my knowledge, the people working on this like myself, Holly, Bob, Dan, Paul .... get no better benefit under "Paul's or Holly's" version that [sic] the original draft/your write up ..... so the statement "pad your own benefits" is wrong.

We're looking at what is fair and reasonable and thinking of the General Members as a whole versus individually. If their [sic] is a specific "hole" or "risk" in the theory that you see as the Retirement Administrator, please let Cathy/Dan/all know immediately because at this point no one has stated any problems with 'Paul's/Holly's' proposed solution in terms of "detriment/harm/risk" to the system, the City, or the members.
Terri[24]

---

[23] 20 May 2002 (10:03 AM) Email from Lawrence Grissom to Terri Webster. (Exhibit 17)

[24] 20 May 2002 (10:26 AM) Email from Terri Webster to Lawrence Grissom regarding "Curmudgeon speaks." (Exhibit 17)

C. DISCUSSION SHIFTS TO GRANTING BENEFITS IN EXCHANGE FOR WAIVING THE TRIGGER

When City officials learned of the impending trigger and multi-million dollar balloon payments, they developed a plan to negate the trigger and avoid the payments. To induce the pension board to take these actions, the City extended new benefits to both City workers and to three union presidents. Thus City officials intended to increase benefits even though the pension plan was unable to pay for hundreds of millions of dollars in benefits already granted.

Emails confirm that pension board members violated their fiduciary duties to protect fund assets in exchange for new benefits that they received.[25] On 21 May 2002, City Auditor Webster sent an email to labor negotiator Dan Kelly, Auditor Ed Ryan, and other City officials seeking reassurance that Fire Fighter Union President Ron Saathoff would prevail on the pension board to waive the trigger and forgive the balloon payment. Mr. Saathoff was to receive a substantial presidential benefit in exchange for his help:

Dan

---

[25] See, San Diego City Charter Article IX § 143; Cal State Constitution Article 16 § 17 (retirement board of public pension plan has "fiduciary responsibility for ... administration of the system.") (Exhibit 18)

> The local 145 write up you sent out did not state that their increased offset was contingent on the Board laxing the trigger.....I thought ALL retirement improvements (including the presidetial [sic] leave(?)) were contingent on the trigger....especially need Ron behind releasing the trigger since he runs the show at CERS.... [emphasis added][26]

Within twenty minutes City labor negotiator Mike McGhee had assured Ms. Webster that Mr. Saathoff was "well aware of the contingent nature of the benefits":

> From: Mike McGhee
> To: Ryan, Ed; Webster, Terri; Kelley, Dan
> CC: Lawrence, Bob; Wilson, Bob; Heap, Elmer
> Date: 5/21/2002 9:42 AM
> Subject: Re: Meet and Confer Update - Changes for FY 2003 / FY 2004 / FY 2005
>
> Dan shared with me your comments Terri. I assure you that Ron is well aware of the contingent nature of the benefits, after our repeated statements at the negotiations table regarding the benefits being contingent upon your noted approvals. Cathy was very specific on those points at every discussion. The various proposals are all specific to the necessary approvals and available funding from the reserves, although this is not stated in this "highlights" to the departments. [emphasis added]

D. THE MAYOR'S BLUE RIBBON COMMITTEE

[26] 21 May 2002 (9:22 AM) Email from Terri Webster to Dan Kelley on the subject of "laxing the trigger." (Exhibit 19)

On 27 April 2001, San Diego Mayor Dick Murphy convened a Blue Ribbon Committee on City Finances "to perform an independent evaluation on the City's current fiscal health."[27] The Mayor designated Auditor Ryan and Assistant Auditor Webster as staff for the Committee. The Blue Ribbon Committee's final report described its charge:

> In Mayor Dick Murphy's January 8, 2001 State of the City Address entitled "A Vision for San Diego in the Year 2020: A City Worthy of our Affection", he outlined ten goals for the City to focus on over the next four years. A concern raised by the Mayor was whether the City could afford to do the ten goals. As a result, Mayor Murphy announced he would convene a Blue Ribbon Committee on City Finances to perform an independent evaluation on the City's current fiscal health and make any appropriate recommendations. Furthermore, the Mayor stated that he would ask the City's independent Auditor and Comptroller Ed Ryan to provide staff support to the Committee.[28]

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[27] Mayor's Blue Ribbon Committee Report on City of San Diego Finances (27 February 2002) p. 2. (Exhibit 20)

[28] 27 February 2002 Blue Ribbon Committee Report on City of San Diego Finances p. 2. (Exhibit 20)

The Blue Ribbon Committee Work Plan called for the final report to be presented to the Mayor on or around 7 September 2001.[29] In fact it was presented to the City Council Rules Committee on 27 February and 20 March 2002, and to the San Diego City Council on 15 April 2002.[30] Richard Vortmann, President of National Steel and Shipbuilding Company ("NASSCO"), was assigned to be the committee's lead person on the Unfunded Pension Liability issue.[31] On 21 September 2001, the Mayor also appointed Mr. Vortmann to the City Employees' Retirement System Board of Administration.[32]

Mr. Vortmann's source of information about the pension funding crisis came from Blue Ribbon Committee staff Ed Ryan and Terri Webster.[33] Mr. Vortmann also received critical financial information about the adverse financial condition of the pension plan from reports provided to him by the plan actuary, plan administrator

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[29] See "Blue Ribbon Work Plan." (Exhibit 21)

[30] 27 February 2002 and 20 March 2002 Rules Committee Agendas; 15 April 2002 City of San Diego City Council Minutes. (Exhibit 22)

[31] 13 July 2001 Minutes of Mayor Dick Murphy Blue Ribbon Committee on City Finances p. 2. (Exhibit 23)

[32] 21 September 2001 Mayor Dick Murphy News for Release "Mayor Murphy Appoints Two to Retirement Board City Council Confirms Vortmann and Garnica." (Exhibit 24)

[33] 27 February 2002 Blue Ribbon Committee Report on City of San Diego Finances p. 2. (Exhibit 20)

Lawrence Grissom, and other pension plan staff and board members.[34]

[34] E.g., see 18 Februaŕy 2002 letter from Mr. Vortmann to Fred W. Pierce IV Chairman San Diego City Employee Retirement System. (Exhibit 25)

By 31 July 2001, Mr. Grissom was communicating with Ms. Webster about pension plan financial matters.[35] On that date Mr. Vortmann, through his assistant Leilani Hughes, submitted his draft conclusions to Ms. Webster and Mr. Grissom; he had reached an assessment that the pension plan was "no big issue:"

> From: Leilani Hughes
> To: TAA.Auditor.cab7-9
> Date: 7/31/2001
> Questions for City Pension Manager
>
> Ms. Webster,
> Mr. Vortmann has asked that I send you the attached with the following note:
>
> Terri
> Thank you for your e-mailed comments.
> ***
> As long as this is comprehended in long term budget planning, then there is no big issue. [emphasis added]
> Dick

One month later, on 30 August 2001, Mr. Vortmann issued a memorandum suggesting that Mr. Vortmann had discovered that problems in the pension plan "were a cause for concern:"

> ***
> However investment performance in YTD FY01 has been less than ½ of that excellent performance in FY00. It is expected that the forthcoming actuarial report will show an increase in the unfunded dollar

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[35] 31 July 2001 (11:27 AM) Email from Mr. Vortmann's assistant Leilani Hughes to City Auditor Terri Webster re: "Questions for City Pension Manager." (Exhibit 26)

amount.

> A point of possible concern is that after an unprecedented 9 year boom in the equity market when many pension plans became flush and actually over funded allowing sponsors to reduce annual cash contributions, the City still has an unfunded liability. This, taken together with the growing annual liability (as a percent of payroll base) for the 'retroactive' pension improvements is a cause for concern.

By the time he wrote his 31 August 2001 memorandum, Mr. Vortmann was already asking for a comprehensive actuarial analysis of the future funding problems at the pension plan:

> At a minimum the City should ask for a comprehensive analysis, based on today's known actuarial facts, to determine for how many years in the future will the pension contribution expense have to increase by a half percentage point of the total payroll base.[36]

By 31 December 2001, two months after he won his appointment to the pension plan board, Mr. Vortmann had taken an even more aggressive stance toward the pension plan funding crisis. On New Year's Eve 2001, Ms. Webster decried Mr. Vortmann's new approach as "Doom and gloom:"

> 5. Maybe you can talk to Dick before Fri and turn him. He's turned all 6, 100%, reported topics into a negative. Doom and gloom ... we're a good looking apple that is rotten once you bit into it.... [emphasis added]

Mr. Vortmann faced substantial pressure not to reveal the whole truth about the pension funding crisis. In an email to auditor Ryan, Ms. Webster celebrated the

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[36] 30 August 2001 Vortmann memorandum "Employee Retirement Benefit Liabilities." (Exhibit 27)

fact that she had stopped Mr. Vortmann from disclosing all that he knew about the pension funding crisis:

> From: Terri Webster
> To: Ryan, Ed
> Date: 7 January 2002
> Subject: my suggestion on Redraft of pension Sections
> Ed,
> I reviewed Dick's changes...it most places he deleted your recent changes and put back his language...but he did in a small way improve his language. I will suggest some changes to his conclusions to more emphasize the point you made in the meeting Re: % of pension to payroll but after a dozen trys [sic] I don't see the values of arguing with him on the wording of the other issues any more and it is too complicated for the rest of the committee to grasp and help change Dick's mind...so I suggest we agree to disagree...we gave a good shot at changing him...he just didn't fall for it..all... [emphasis added][37]

On 12 February 2002, Mr. Vortmann was notified that the pension plan funding ratio had dropped from 97.3% to 89.9%.[38] Fifteen days later, on 27 February 2002,

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[37] 7 January 2002 (5:12 PM) Email from Terri Webster to Ed Ryan on the subject of "my suggestions on Redraft of Pension Sections." (Exhibit 52)

[38] 30 June 2001 San Diego City Employees' Retirement System Annual Actuarial Valuation p. 13 (Exhibit 12); 18 February 2002 letter form Mr. Vortmann to

he presented the City Council Rules Committee with the Blue Ribbon Committee's report, which misrepresented the pension plan's funding ratio to be at 97.3%.[39]

Mr. Frederick W. Pierce, IV (Exhibit 25).

[39] 27 February 2002 Blue Ribbon Committee Report on City of San Diego Finances p. 22 ("It is currently funded at 97% (i.e. its current assets equaled 97% of the actuarially computed present value of the future Pension Plan Liabilities.)." (Exhibit 28)

Despite the fact that the Committee Report was partially revised on 14 February 2002, it was not changed to show that the plan's funding ratio had dropped to 89%.[40] Mr. Vortmann recorded his knowledge of this fact in an 18 February 2002 letter to pension board Chairman Fred Pierce:

> My reading of the new actuarial report[41] raises several questions. Possibly some (or all) are due to my ignorance but I am concerned there are some significant issues buried here. I would respectfully request that staff address these to assure the full Board truly understands what is happening (or educate me separately if I'm the problem).[42] [emphasis added]

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[40] Compare 24 January 2002 draft of Blue Ribbon Committee Report on City of San Diego Finances p. 21 ("Investment performance in the first five months of Fiscal Year 2002 is lower than in Fiscal Year 2001.") (Exhibit 29) to the 14 February 2002 draft ("Investment performance in the first seven months of Fiscal Year 2002 is lower than in Fiscal Year 2001.") (Exhibit 30).

[41] See, 30 June 2001 San Diego City Employees' Retirement System Annual Actuarial Valuation p. 13 showing the pension plan's funded ratio dropping 8% to 89.9%. (Exhibit 12)

[42] 18 February 2002 letter from Richard Vortmann to Frederick W. Pierce IV. (Exhibit 25)

Mr. Vortmann recognized that the pension plan was a "big issue" and that because of it, a storm cloud was brewing over the City:

> Am I confused here? If not, this is a rather big issue- i.e. the $105m can't be used twice. A funded ratio at 85.6% is getting close to the 82.3% trigger where the current "unconventional" actuarial method is violated.
>
> 89.9%-> 85.6% (if Reserve is a true reserve) -> 83.1% (if Corbett [sic] not contingent)
>
> ***
>
> 14C. The "brewing storm cloud" needs to be fully explained.[43]

When the report was presented to the Rules Committee, Mayor Murphy made comments revealing his personal knowledge of some of the pension funding issues:

> One issue is that we are not currently providing funding to make the pension fund whole, I guess for the lack of a better term. In other words, we should be putting 6 or 8 million dollars in a year or more to make it actuarially sound.[44] [emphasis added]

Although Mr. Vortmann had a strong sense that the pension plan's actuary was covering his tracks, his suspicion went undisclosed:

> I get a very strong sense of 'game playing' or anticipator 'ass covering' by the Actuary. This is most disturbing. How can they say the 'system

---

[43] 18 February 2002 letter from Richard Vortmann to Frederick W. Pierce IV. (Exhibit 25)

[44] 8 February 2005 Transcription of City Council Rules Committee Discussion of 27 February 2002. (Exhibit 31)

continues to be in sound condition in accordance with actuarial principles of level cost financing.' The actual practice is **not** 'level cost funding.'[45] [emphasis added]

In the days following the report's release, Mr. Grissom joked with Ms. Webster about telling a *San Diego Union-Tribune* reporter that the City was failing to properly fund the pension plan:

> Lawrence Grissom 3/07/02 (4:58 PM)
> Hi Terri
> Just got a call from Ray Huard at the Tribune wanting comment on the report's statement that the City is seriously funding [sic] its retirement plan. I told him that I had not had the opportunity to read the report and would like to before I made any comment.
>
> Thnik [sic] I'll tell him that we are seriously underfunded due to the City not paying it's fair share.....OK with you???
> Seriously, is there any "party line" for me to communicate?

[45] 18 February 2002 letter from Richard Vortmann to Frederick W. Pierce IV. (Exhibit 25)

Larry[46]

Within two weeks of the report's release, Mr. Grissom informed Mr. Vortmann that daily discussions were occurring about the consequences of hitting the trigger:

> From: Lawrence Grissom
> To: [Mr. Vortmann]
> Date: Wed, March 13, 2002 5:15 PM
> Subject: Response to your questions
> If the current funding ratio were at or below 82.3%, they would go to the actuarial rate of 15.59%. This would represent an additional dollar contribution of approximately $25.2 million, which is more than Cathy's estimate of $20 million.
> ***

[46] 7 March 2002 (5:56 PM) Email from Terri Webster to Lawrence Grissom on the subject of "Blue Ribbon Report." (Exhibit 32)

> Yes, staff has discussed this situation at length with City management. Currently, there is some discussion of the issue almost daily. [emphasis added]
> Larry[47]

The pension problem reported on by the Blue Ribbon Committee was shuffled from one part of City government to another. On 27 February 2002, the report went to the Rules Committee.[48] From there it was sent to the City Manager. On 20 March 2002, the City Manager returned the report to the Rules Committee.[49] The Rules Committee then sent the Report to the City Council. The Council passed it on to the Pension Board. A year later the board brought it back to the Rules Committee. The Rules Committee then sent it to the City Manager. The Manager returned it to the Mayor. Then the Mayor gave the report to the Pension Reform Committee. And finally it was returned to the City Council.

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[47] 13 March 2002 (5:16 PM) Email from Lawrence Grissom to Dick Vortmann regarding "Response to your questions." (Exhibit 33)

[48] 27 February 2002 San Diego City Council Rules Committee Action. (Exhibit 34)

[49] 18 March 2002 City Manager Report "Response to the Blue Ribbon Committee Report" (Report No. 02-061). (Exhibit 35)

Mayor Murphy attributed his failure to take on the pension problem in 2002 to a desire not to violate "protocol:"

> The Retirement Board has the legal responsibility under the Charter to oversee the operation of the retirement system and so my recollection is that we only indirectly control what they do. So, to come directly here with a workshop at least seems to violate protocol, if not, losing the lack of Retirement Board thoughts and input on this.[50]

In 2002 Mayor Murphy detailed his knowledge of the deliberate underfunding of the pension plan but attempted to dismiss the seriousness of the problem:

> "T]here was, perhaps some decisions made by prior City Councils that deliberately under funded the pension system, in order to cover their budget deficits in the 90s, I mean I don't think it is like a crisis situation but it is a serious situation and we need to address it.[51]

Mayor Murphy then zeroed in on the Meet and Confer process that the Mayor and City Council were beginning and how it should affect the pension funding issue:

> So, even though I agree with Mr. Vortmann, there is some sense of, there is a need for us to understand that there has been historically an under funding of the retirement system, this year in the meet and confer process we need to be aware of that when we negotiate.[52]

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[50] Transcription of City Council Rules Committee Discussion of 20 March 2002. (Exhibit 36)

[51] Transcription of City Council Rules Committee Discussion of 20 March 2002. (Exhibit 36)

[52] Transcription of City Council Rules Committee Discussion of 20 March 2002. (Exhibit 36)

Finally, the Mayor tried to dismiss the seriousness of the problem by claiming that the funding ratio was "in excess of 90%:"

> And you recall that the numbers here on the report show that the funding in some where between, in excess of 90 percent of the needs of the system, but 100 percent would be the ideal way to operate ....[53]

On 29 April 2002, Mr. Vortmann sent a revealing letter to his fellow Blue Ribbon Committee board members, to auditors Ed Ryan and Terri Webster, and to Dennis Gibson, the Mayor's Senior Policy Adviser. In the letter, Mr. Vortmann admitted that the pension portion of the Blue Ribbon Report was materially false:

> After much discussion of whether the "sky was really falling" and did we really want to say all that, we, as a group, with my concurrence, evolved to the final version of our conclusion i.e. "The city in good fiscal shape, but ..."
>
> Interesting, the several "citizen comments" I have received regarding our report have all been essential [sic] the same – "yeah, my balance sheet and credit rating would be good too. If I didn't maintain my house and pay all my expenses."
>
> The committee's unstated concern over the ball park financing and any impact to the city's credit rating in general are now behind us. However certain recent developments since our report deliberation seems to accentuate the "buts" we made in our report.
> ***
> Fourth, as I continue to learn more about the City's pension system, coupled with the impact of the equity market bubble burst on the pension

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[53] Transcription of City Council Rules Committee Discussion of 20 March 2002. (Exhibit 36)

> portfolio, it is clear the City has deferred to future taxpayers far more dollars than our report assumed. Further, there appears a chance the City will grant further pension benefits this year which will either increase the pension budget line item or (more likely) push yet more current costs out to future taxpayers. Unlike deferred maintenance, these are mandatory costs which ultimately must be paid; and these amounts explicitly grow with interest when they are deferred.
>
> I have a growing and daunting concern that we possibly did our City a disservice by not ringing a very loud bell that:
>
> i) the City's fiscal health is not what it appears,
> ii) there are serious problems,
> iii) their solutions will be painful in terms of reduced services and/or increased taxes and fees, and
> iv) a comprehensive multi-year strategic plan to deal with the situation must immediately be developed; difficult decisions must be made now.[54]

Was this letter shared with Mayor Murphy? Mr. Vortmann has declined a request from the City Attorney to be interviewed about this matter. Mr. Gibson, Mayor Murphy's Senior Policy Adviser, who received a copy of the letter, has also refused the City Attorney's request for an interview.

The Mayor was quoted in the *San Diego Union-Tribune* as stating that Mr. Gibson had not shared Mr. Vortmann's 29 April 2002 letter with him:

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[54] 29 April 2002 letter from Richard H. Vortmann to Blue Ribbon Committee members and City officials. (Exhibit 37)

> Murphy said yesterday that Gibson never showed him the letter. He said his chief of staff, John Kern, told him Gibson never gave him the letter, either. "He probably should have showed it to me, but I get hundreds of letters, and particularly those that aren't even addressed to me I would not normally see," Murphy said. Knowing Vortmann's concerns in April 2002 might not have changed the way the council voted on the pension system later that year, Murphy said. "By the spring of '02, the city manager was discussing with us this whole underfunding issue and how to deal with it," Murphy said. "One letter, would that have made a difference? I don't know."[55] [emphasis added]

E. COUNCIL'S KNOWLEDGE OF PENSION FUNDING CRISIS

The City Council is required to adopt an ordinance setting salaries for all City employees each year:

> The City Council shall annually adopt an ordinance establishing salaries for all City employees. The City Council shall adopt this ordinance not later than May 30 of each year ....[56]

The City Council may enter into multiple year agreements with its recognized labor organizations:

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[55] 3 February 2005 San Diego Union-Tribune article (Matt T. Hall) "S.D. panelist's memo warned of fiscal woes." (Exhibit 38)

[56] San Diego City Charter Article III § 11.1. (Exhibit 39)

> Notwithstanding any provisions of this Charter to the contrary, nothing in the Charter shall be construed to preclude the Council from entering into a multiple year memorandum of understanding with any recognized City employee organization concerning wages, hours and other terms and conditions of employment if, in the prudent exercise of legislative discretion as provided in this Charter, the Council determines it is in the best interests of the City to do so; and further provided that said exercise of legislative discretion is expressed affirmatively by a two-thirds vote of the entire Council.[57]

In the spring of 2002 the City Council[58] began negotiating a multi-year agreement regarding salary and benefits. Within the City these negotiations are referred to as "Meet and Confer." The Mayor and Council learned facts about the pension plan funding crisis, the trigger and balloon payments during their closed session briefings and discussions. These briefings and discussions began by 26 February 2002.[59]

The Council eventually embraced a plan to pay increased pension benefits in exchange for a waiver of the 1996 trigger and balloon payment agreement:

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[57] San Diego City Charter Article III § 11.2. (Exhibit 39)

[58] At that time the City Council included Mayor Dick Murphy, Council members Scott Peters, Toni Atkins, George Stevens, Byron Wear, Brian Maienschein, Donna Frye, Jim Madaffer, and Ralph Inzunza.

[59] 21 February 2002 Closed Session Agenda Items for 26 February 2002 "Conference with Labor Negotiator, pursuant to Government Code § 54957.6: Agency negotiators: Michael Uberuaga, Lamont Ewell, Cathy Lexin, Dan Kelley, Stanley Griffith, Mike McGhee; Employee organizations: Municipal Employees Association, Local 127AFSME, AFL-CIO, Local 145 International Association of Firefighters AFL-CIO, San Diego Police Officers Association. (Exhibit 40)

> Substantial benefit improvements granted by the City since the adoption of the 'City Manager's Retirement Proposal' dated July 23, 1996 (Manager's Proposal) have created additional un-funded liability to SDCERS that was not anticipated when the City agreed to the 'trigger' provisions.
>
> Significant improvements in benefits are contained in this three-year proposal. Consequently, the 'trigger' provisions must be adjusted as a condition of the City's three-year proposal, therefore, this three year proposal is contingent upon, and subject to, approval by the SDCERS Board of Trustees of an adjustment to the 'trigger' provisions contained in the Manager's Proposal.[60]

On 15 March 2002 City labor negotiator Daniel E. Kelley provided the Council with "Closed Session Meet and Confer Material for March 18, 2002."[61] Included with the material was a PowerPoint presentation for the "extended 9 a.m. to 12 p.m. meeting on Monday, March 18, 2002." PowerPoint Slide number 51 explained how the pension plan actuary computes the annual valuation:[62]

/ / /

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[60] 24 May 2002 Memorandum to Honorable Mayor & City Council from Daniel E. Kelley, Labor Relations Manager, regarding "Final Three Year offer to San Diego Police Officers Association." (Exhibit 41)

[61] 15 March 2002 Memorandum to Mayor and City Council providing Closed Session Meet and Confer Materials for March 18, 2002. (Exhibit 42)

[62] 15 March 2002 Memorandum to Mayor and City Council providing

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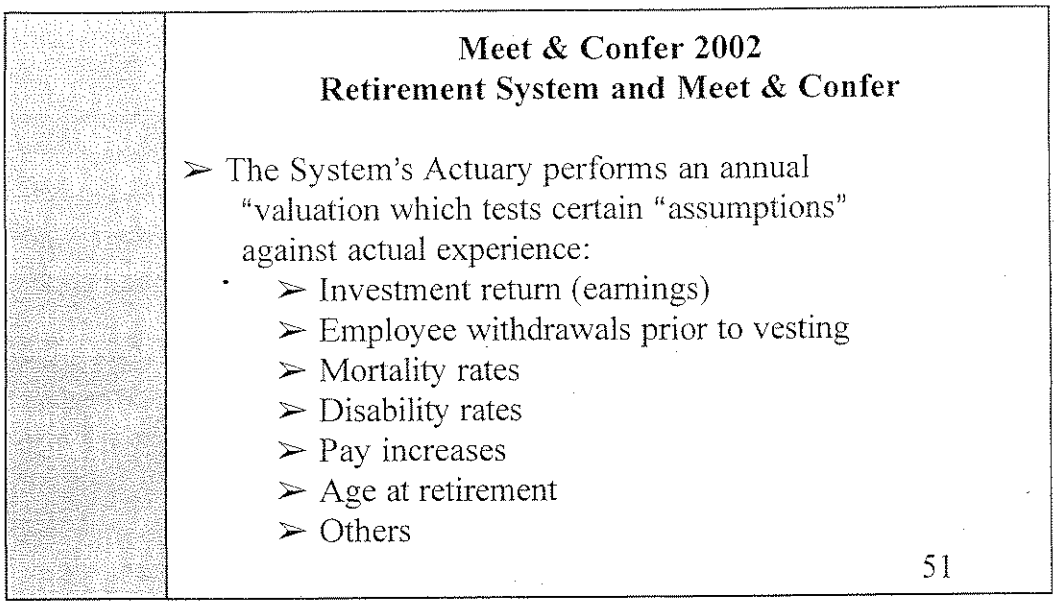

Closed Session Meet and Confer Materials for March 18, 2002, Slide 51. (Exhibit 42)

Slide 52 disclosed to Council Members that the pension plan's funding ratio had dropped to 89.9% by 2001:[63]

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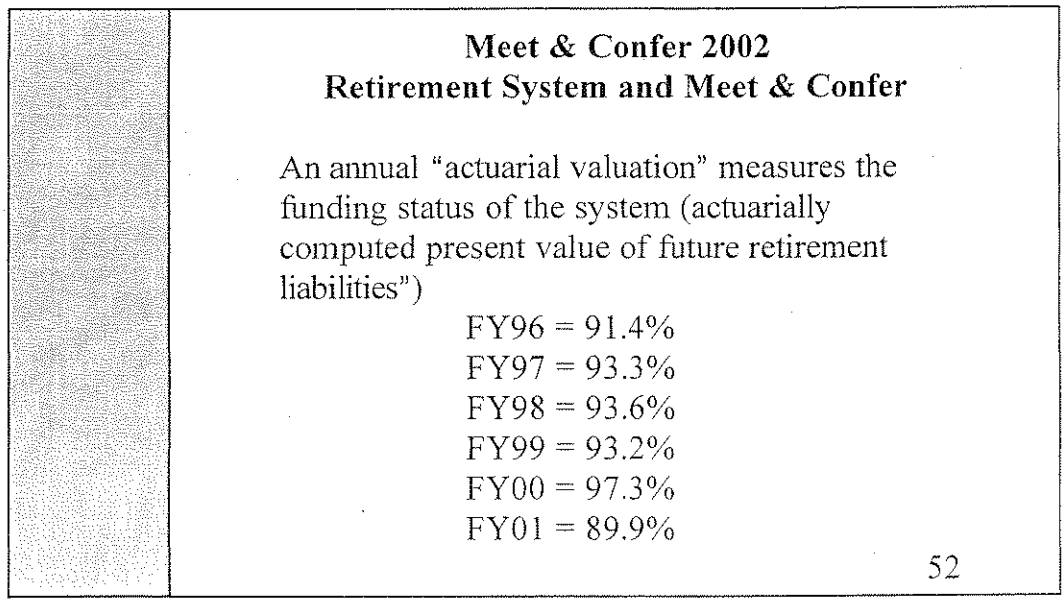

[63] 15 March 2002 Memorandum to Mayor and City Council providing Closed Session Meet and Confer Materials for March 18, 2002, Slide 52. (Exhibit 42)

Slide 65 explained how the "Rate Stabilization Plan" had worked under Managers Proposal 1. It also set forth the decline in earnings experienced and that created the 2002 funding crisis:[64]

Meet & Confer 2002

Employer Contribution Rate Stabilization Plan

Period	PUC Rate	Actual Rate	City Paid Rate	Difference %	Difference $	Earnings
FY96	8.60%	8.60%	7.08%	1.52%	$5.33m	$150.4m
FY97	10.87%	9.55%	7.33%	3.79%	$13.88m	$137.4m
FY98	12.18%*Est	10.87%	7.83%	4.35%	$16.67m	$247.4m
FY99	12.18%*Est	10.86%	8.33%	3.85%	$15.40m	$189.1m
FY2000	12.18%*Est	11.48%	8.83%	3.35%	$14.00m	$415.9m
FY2001	12.18%*Est	11.96%	9.33%	2.85%	$12.45m	$168.0m
FY2002	12.18%*Est	12.58%	9.83%	2.35%	$10.72m	$52.0m est
FY2003	12.18%*Est	15.59%	10.33%	1.85%	$8.82m	
FY2004	12.18%*Est		10.83%	1.35%	$6.73m	

[64] 15 March 2002 Memorandum to Mayor and City Council providing Closed Session Meet and Confer Materials for March 18, 2002, Slide 65. (Exhibit 42)

FY2005	12.18%*Est		11.33%	.85%	$4.43m	
FY2006	12.18%*Est		11.83%	.35%	$1.91m	
FY2007	12.18%*Est		12.18%	-0-	-0-	
FY2008	13.00%*		13.00%	-0-	-0-	
Total					$110.35	
						Slide 65

The minutes from the 18 March 2002 Closed Session City Council meeting refer to discussions about and a vote taken on the several meet and confer issues, including a "willingness to discuss retirement + trigger."[65]

On 16 April 2002 the City Council again met in Closed Session to discuss meet and confer issues, including those related to the pension funding crisis. PowerPoint slides 16 and 17 made specific reference to the Council conditioning the granting of more pension benefits on a waiver of the "trigger:"[66]

	Meet & Confer 2002 **Authorization of Final Economic**

[65] 18 March 2002 Closed Session Report City of San Diego. (Exhibit 43)

[66] 16 April 2002 Closed Session Presentation, Slide 16. (Exhibit 44)

Bargaining Authority (Action)

Management Team Recommendation:

- Authorize removal of MVLF contingency language
- Authorize the proposed three year agreement as the City's final economic bargaining position
- Condition all retirement enhancements on removal of the "trigger" in the "Managers Proposal regarding CERS funding ratio*
  - Retiree health
  - Increase in Pickups
  - Increase in General Member Formula

*If CERS funding ratio drops below 82.3% (currently 89.9% City must pay full actuarial rate, $25m more annually.

16

Again, Slide 17 repeats the statements about conditioning all retirement enhancements on removal of the "trigger:"[67]

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Meet & Confer 2002

[67] 16 April 2002 Closed Session Presentation, Slide 17 and copy of Slide 17 with handwritten notes. (Exhibit 45)

Authorization of Final Economic Bargaining Authority (Action)

Management Team Recommendation:

- Authorize removal of MVLF contingency language
- Authorize the proposed three year agreement as the City's final economic bargaining position
- Condition all retirement enhancements on removal of the "trigger" in the "Managers Proposal regarding CERS funding ratio*
  - Retiree health
  - Increase in Pickups ***until CERS reserve depleted***
  - Increase in General Member Formula

*If CERS funding ratio drops below 82.3% (currently 89.9% City must pay full actuarial rate, $25m more annually.

17

A hand written note on a copy of slide 17 states "approved 6-3 At, Ar, Inz." The Closed Session Report from the 16 April 2002 meeting shows districts 3, 4 and 8 voting no on the Manager's proposal considered at the Closed Session.[68]

The Mayor and Council met again to discuss meet and confer issues in Closed Session six (6) days after the Council's 16 April 2002 meeting, on 22 April 2002. Closed Session minutes show several 9 to 0 votes taken on the Manager's proposal. No writings were located indicating whether the pension trigger and balloon payment

[68] 12 April 2002 Closed Session memorandum to Mayor and City Council from Cathy Lexin, Human Resource Director, and Elmer Heap Deputy City Attorney regarding the subject of "Closed Session Met and Confer Agenda for April 15, 2002."

issues were discussed by the Mayor and Council.

The Mayor and Council returned to Closed Session on meet and confer matters on 29 April 2002. The Closed Session agenda for the 29 April 2002 Closed Session meeting includes a subsection under "Management Team Recommendations for Bargaining Authority," entitled "Funding Ratio and Impact on City's Contribution Rate." PowerPoint slides attached to the 29 April 2002 Closed Session memorandum (Slides 27-31) include references to the funding ratio trigger of 82.3%, waiving the trigger in exchange for new benefit grants, and the status of the under funding ratio.[69] Slide 27 shows funding ratio information was to be presented to the Council. It also shows the benefits that were to be give in exchange for a waiver of the trigger:

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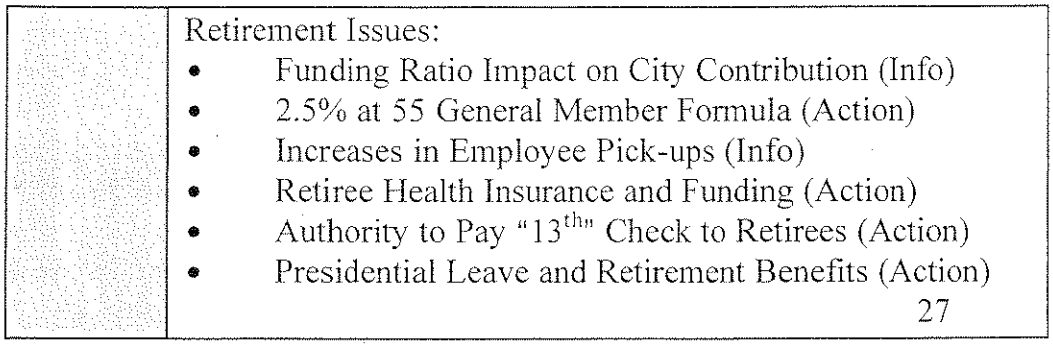
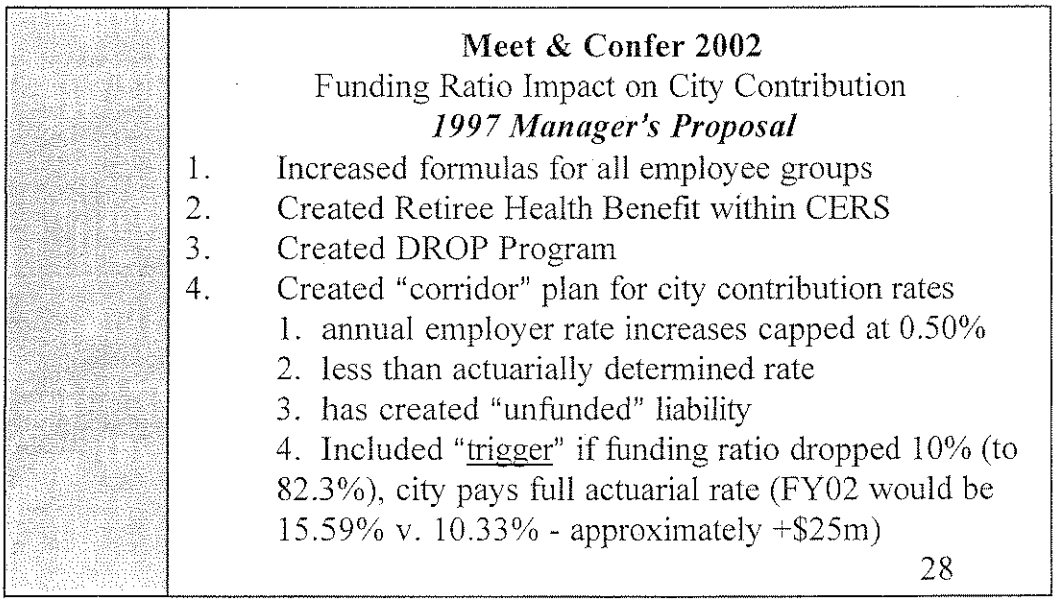
	Meet & Confer 2002
	Retirement Issues:

[69] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002." (Exhibit 46)



Slide 28 of the PowerPoint included with the 26 April 2002 Closed Session Memorandum provides detailed information regarding the funding ratio's effect on the City's pension contribution:



On Slide 29, the effect of the funding on the City's pension contribution is discussed in terms of the current funding ratio. City staff represented to the Council that the funding ratio trigger would require the City only to pay the "full actuarial rate" of approximately $25 million. However, the 1997 Managers Proposal ("MP 1")

required the City Council to maintain the funding ratio at 82.3%. In June 2002 the plan's funding ratio fell to 77.3% - - 5% below the trigger point of 82.3%. In order to return the funding level to 82.3%, the Council was required to make a balloon payment of $159 million. The City was required to pay 5% of the Actuarially Accrued Liability in order to bring the funding level back up to 82.3%. The Actuarially Accrued Liability in June 2002 was $3,168,921. Five percent of the Actuarially Accrued Liability (.05 x $3,168,921) is $159 million.[70]

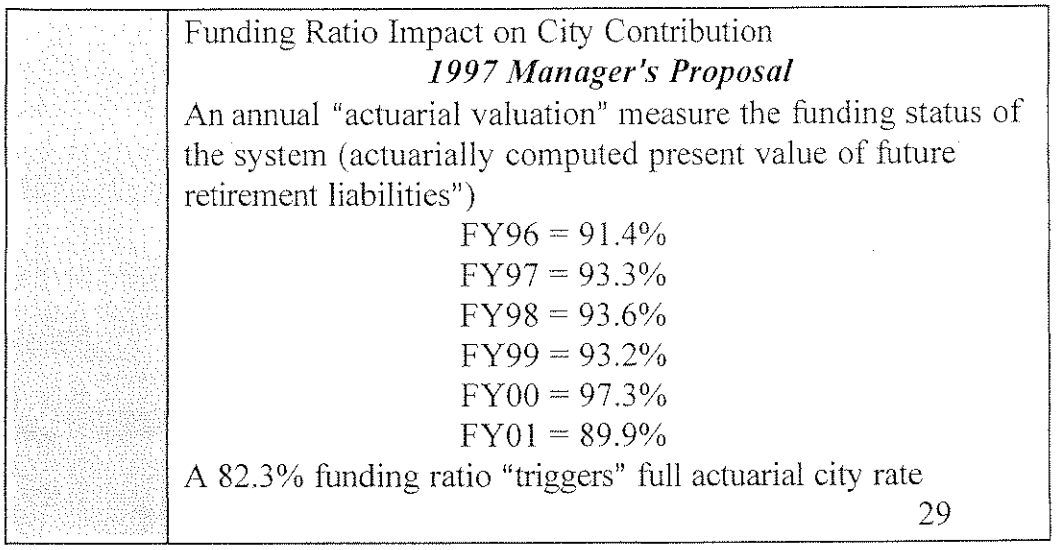
Slide 29 of the PowerPoint for the 29 April 2002 Closed Session Meeting of the City Council shows the actuarial funding ratio dropping 8% to 89.9% during fiscal year 2001:

/ / /

/ / /

/ / /

[70] The City's duty to keep the plan at a funding ratio is set forth in the 23 July 1996 memorandum from Cathy Lexin to Larry Grissom re: "City Manager's Retirement Proposal (Exhibit 5); the Actuarially Accrued Liability for 2002 is contained in the San Diego City Employees' Retirement System Annual Actuarial Valuation 30 June 2002 p. 13 (Exhibit 48).



Slide 30 paints an even more detailed picture of the funding ratio sliding toward the trigger point. This slide includes a specific reference to an estimated drop in plan earnings from $168 million in fiscal year 2001, which saw a 8% drop in the funding ratio, to $20 to $30 million in fiscal year 2002. In fiscal year 2002 the funding ratio would drop 12.6% to 77%.[71] Slide 30 contains a comparison between plan earnings and the plan's funding ratio. It shows that even with the plan earning over $1.1 billion between fiscal year 1996 and 2000, a negative funding ratio (97.3%) occurred in fiscal

[71] San Diego City Employees' Retirement System Annual Actuarial Valuation 30 June 2002 p. 13. (Exhibit 48)

year 2000.[72]

Slide 30 of the PowerPoint for the 29 April 2002 meeting painted a substantial part of the under funding picture for the Mayor and Council:

Meet & Confer 2002

Funding Ratio Impact on City Contribution

1997 Manager's Proposal

Earnings Compared with Funding Ratio

FY96	$150.4 m	91.4%
FY97	$137.4 m	93.3%
FY98	$247.4 m	93.6%
FY99	$189.1 m	93.2%
FY00	$415.9 m	97.3%
FY01	$168.0 m	89.9%
FY02 Est.	$20 to $30 m	?

- $105 m reserve would drop to = 85.6%
- "Trigger" in Manager's Proposal = 82.3%

30

[72] The Pension Reform Committee found in 2003 that only 6% of the under funding problem was due to earnings losses; see, City of San Diego Pension Reform Committee page 11 of 74. (Exhibit 49)

The report for the 29 April 2002 Closed Session Council meeting shows votes were taken on ten meet and confer issues. On nine (9) of the issues the vote was nine in favor none opposed. On the issue of retroactively awarding 2.5% and allowing retirement at age 55, Council District 6 (Ms. Frye) voted in the negative.[73]

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[73] Closed Session Report for the 29 April 2002 San Diego City Council Closed Session. (Exhibit 50)

Another slide (31) included in the 29 April 2002 Closes session materials provided that the "Management team has and will: 1. Include contingencies that address the 'trigger' concern in all retirement enhancements that create additional unfunded liability."[74]

Slides 27, 32, 36, 38, 43, and 46 of the PowerPoint included with the 29 April 2002 Closed Session of the City Council and Mayor make specific reference to "Presidential Leave and Retirement Benefits" as one of the "retirement issues" for which council "action" is required.[75] The "Presidential Leave and Retirement Benefits" refers to a proposal approved by the City Council in 2002 that gave certain special benefits to the Presidents of the Firefighters Union and the Municipal Employees Association ("MEA").[76]

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[74] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002." (Exhibit 46)

[75] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002." (Exhibit 46)

[76] The Police Officers Association President was not included in the final meet and confer agreement which, as to the Police Officers Association, went to

"impasse" in 2002.

Slide 35 from the 29 April 2002 Closed Session describes the City Manager's "Retirement Formula Improvement."[77] It calls for an increase in "general retirement benefit enhancement of 2.5% @ 55, with contingencies that Unions support and CERS Board of Administration agrees to." It also called for absorption of "Past Liability of the 2.50% at 55 benefit into CERS assets as an unfunded liability." This last funding change was predicted to "reduce funding ratio 1% to 1.5%."[78]

Slide 35 from the 29 April 2002 Closed Session meeting of the City Council reads:

Meet & Confer 2002
Funding the General Member
Retirement Formula Improvement
Modifications to Previous Authority:
Approve General Member retirement benefit enhancement of 2.5% @ 55, with contingencies that Unions support and CERS Board of Administration agrees to:
A. Eliminate or *Reduce* the "trigger" established in the 1997 Manager's Proposal to 75%
B. If funding ratio "triggers" an increase in City's contribution rate, *phase in over 5 year period*
C. Absorb Past Liability of the 2.50% at 55 benefit into CERS assets as an unfunded

[77] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 35). (Exhibit 51)

[78] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 35). (Exhibit 51)

	liability (this will reduce funding ratio 1% to 1.5%) 35

For fourteen (14) years Judie Italiano, president of the Municipal Employees Association, has been making contributions to the retirement system based upon her MEA salary.[79] Her payments to and participation in the City employee pension plan have been found to be unlawful under federal tax laws.[80] MEA, Ms. Italiano's union employer, is not a San Diego City Employees' Retirement System employer. Therefore, the pension plan should not have accepted the MEA as a plan participant. This decision threatens the tax-exempt status of the San Diego City Employees' Retirement System.[81]

A 13 June 2002 memo from Cathy Lexin, San Diego City Human Resources Director, to the Mayor and City Council brought essential facts of this problem to their attention:

> "While the City maintained its position that it never condoned this arrangement, it was clearly acquiesced to by the City Retirement

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[79] 13 June 2002 memorandum from San Diego City Human Resources Director Cathy Lexin to the Mayor and City Council. (Exhibit 53)

[80] 29 October 2004 memorandum from SDCERS Administrator Lawrence Grissom to San Diego City Manager Lamont Ewell. (Exhibit 54)

[81] 29 October 2004 memorandum from SDCERS Administrator Lawrence Grissom to San Diego City Manager Lamont Ewell. (Exhibit 54)

Office."[82]

Rather than putting a stop to the illegal practice of accepting payments from non-plan participants during the 2002 meet and confer process, the Council was asked to extend the scheme to Ron Saathoff, president of the Firefighters Union:

> As you may recall, two of the four Union Presidents, Bill Farrar of POA and Judie Italiano of MEA, have been on leave without pay for two and fourteen years respectively. Both Mr. Farrar and Ms. Italiano have been making contributions to the retirement system based on the salary their respective Unions have been paying them. While the City maintained its position that it never condoned this arrangement, it was clearly acquiesced to by the City Retirement Office.

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[82] 13 June 2002 memorandum from San Diego City Human Resources Director Cathy Lexin to the Mayor and City Council. (Exhibit 53)

Ron Saathoff, President of Local 145, had requested a similar arrangement approximately one year ago and that matter became a part of these negotiations as well. As a condition of reaching agreement on successor MOU's, the Council approved the Management Team's recommendation to allow the Union-paid salary (not to exceed the salary of the Labor Relations Manager as a cap) as the basis for retirement benefit calculations.[83]

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[83] 13 June 2002 memorandum from San Diego City Human Resources Director Cathy Lexin to the Mayor and City Council. (Exhibit 53)

Slides 47-52 from the 29 April 2002 Closed Session of the San Diego City Council described the "Presidential Benefit" in precise and exact detail. It set forth the employment status and source of wages for each of the union presidents of the Police Officers Association, Firefighters Union Local 145, and the Municipal Employees Association President:[84] the POA and MEA presidents were each identified as a "Full-time Union President" who had "Unpaid Leave from the City:"[85]

Meet & Confer 2002
Union Presidential Leave & Retirement Benefits
Current Status of Union Presidents

Union	President	Status
POA	Bill Farrar	Full-time Union president Unpaid Leave from City
Local 145	Ron Saathoff	Full-time employee. Release time for Union activities
MEA	Judie Italiano	Full-time Union president Unpaid Leave from City
Local 127	Tony Padilla	Full-time employee. Release time for Union activities

47

Slide 48 from the 29 April 2002 Closed Session meeting of the City Council went on to describe the retirement benefit that was approved by the City Council for

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[84] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slides 47-52). (Exhibit 55)

[85] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 47). (Exhibit 55)

Ms. Italiano during the 2002 Meet and Confer. As stated above, the City was unable to reach agreement with the Police Officers Association during the 2002 Meet and Confer:

Meet & Confer 2002

Union/President	Employment Status	Retirement Issue
MEA Judie Italiano	- Leave of Absence 14 years -Payroll Specialist -Full-time MEA President & General Manager	-Purchase past service -Contributes to Retirement on Union Salary ($102,128) -Retirement formula= high one year on union salary*
POA Bill Farrar	-Leave of Absence 2 years -Police Officer II -Full time POA President	-All Service Paid -Contributions to Retirement on union salary ($82,300) -Retirement formula= High one year on Union salary*

*Approximate un-funded liability

Judie Italiano $145,000

Bill Farrar $56,000

48

Slide 49 from the 29 April 2002 PowerPoint presentation to the City Council set forth the Management Team's recommendation for MEA and POA union presidents:[86]

/ / /

[86] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 49). (Exhibit 55)

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Meet & Confer 2002
Union Presidential Leave & Retirement Benefits
Issue 1 - Current Union Presidents

Management Team Recommendation:
• Authorize inclusion of union salary in high one-year calculation; establish a maximum retirement high one-year salary at level equal to City Labor Relations Manager (approx. $108k)

49

The next slide, Slide 50, from the 29 April 2002 Closed Session Meeting of the City Council, described the retirement and employment benefits that were to be provided to "Prospective Union Presidents:"

Meet & Confer 2002
Union Presidential Leave & Retirement Benefits
Issue 2: Prospective Union Presidents

Management Team Recommendation:
• City to allow each union to have a full-time City-paid union President
• Union President/employee to be paid for normal work period at current level and receive current benefits with *no* overtime
• Union President to be entitle to retirement benefits consistent with his/her classification and level of compensation
• Union may compensate the union president for services to the union outside the normal work period. Such compensation shall not affect or be a part of City compensation, nor affect or add to retirement benefits

	• Subject to final review and clearance by City Attorney Estimated Cost: $170,000 annually for two active presidents 50

The President of Firefighters Local 145 was provided for separately in the PowerPoint presentation for the 29 April 2002 Closed Session. First, in PowerPoint Slide 51, Ron Saathoff, president of Firefighters Local 145, was identified as a "Full-time City employee."[87] In another column of Slide 51, the "Retirement Issue" was described as "Use City salary and union salary for high one year calculation (approx. $80k + 40K = $120k).[88] In the 29 April 2002 PowerPoint presentation, the Management Team Recommendation was to "not authorize inclusion of union salary in high one-year calculation" for Firefighter president Saathoff.[89] However, an

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[87] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 51). (Exhibit 55)

[88] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 51). (Exhibit 55)

[89] 26 April Closed Session Memorandum on the Subject of "Closed Session

alternative also contained in the Management Team Recommendation was to "Treat current President under Issue 1, combine City salary and Union salary; cap retirement high one-year salary at level equal to City Labor Relations Manager (approx. $108k).[90]

Meet and Confer Agenda for April 29, 2002" (Slide 52). (Exhibit 55)

[90] 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 52). (Exhibit 55)

Slide 51, identified as "Issue 3," the "Requested Presidential Leave for Local 145 :

Meet & Confer 2002
Union Presidential Leave & Retirement Benefits
Issue 3 - Requested Presidential Leave for Local 145

Union/President	Employment Status	Retirement Issue
Local 145 Ron Saathoff	- Full-time City employee - Fire captain	- Use City salary and union salary for high one year calculation (approx. $80k + $40k = $120k) - No retirement contribution made on union salary*

* Approximate Unfunded Liability $100,000

51

Slide 52 set out the Manager's recommendation that Firefighter President Saathoff should not be permitted to include his salary in the calculation of his City retirement benefit:

Meet & Confer 2002
Union Presidential Leave & Retirement Benefits
Issue 3 - Requested Presidential Leave for Local 145

Management Team Recommendation:
• Treat current President under Issue 2; do not authorize inclusion on union salary in high one-year calculation.

Alternative:
Treat current President under Issue 1, combine City salary and Union salary; cap retirement high one-year salary at level equal to City Labor Relations Manager (approx. $108k)

	52

Although at the 29 April 2002 closed door session the Management Team appears to have recommended against allowing Firefighter Union president Ron Saathoff to include his union income in his City retirement benefit, the Manager changed his position and eventually recommended in favor of Mr. Saathoff. The revised position of the Management Team is described in the 13 June 2002 memorandum from Human Resources Director Cathy Lexin to the Mayor and City Council: "the Council approved the Management Team's recommendation to allow the Union-paid salary (not to exceed the salary of the Labor Relations Manager as a cap) as the basis for retirement benefit calculations."[91]

[91] 13 June 2002 memorandum from San Diego City Human Resources Director Cathy Lexin to the Mayor and City Council. (Exhibit 53)

It appears that at the 29 April 2002 Closed Session meeting the Council unanimously approved the proposed retirement benefit that would allow the POA President to include his Union salary in City retirement calculation.[92] Minutes of the 30 April 2002 Closed Session meeting of the City Council shows that the presidential leave proposal was approved for the MEA and POA presidents on a nine in favor, zero opposed vote: "Presidential leave MEA & POA only Mgr. Recommendation-base retirement on high 1 year union salary. 9-0-0." The same minutes show that the presidential retirement issue for Firefighter president Ron Saathoff was trailed one week: "145- Trail 1 wk."[93]

The next Closed Session Council meeting to consider the retirement issues and the presidential leave retirement calculations was on 6 May 2002.[94] Slide 4 from the PowerPoint Closed Session presentation on 6 May 2002 reiterated the City Council's position that "all retirement enhancements" were "conditioned" on "removal of the 'trigger' in 'Manager's Proposal' regarding CERS funding ratio:"

	Status of Negotiations

92 29 April 2002 Closed Session Report which reflects a 9-0 vote on the POA Safety Requirement Status. (Exhibit 50)

93 Minutes of 30 April 2002 Closed Session City Council Meet and Confer meeting. (Exhibit 56)

94 Minutes of 6 May 2002 Closed Session City Council Meet and Confer meetings. (Exhibit 57)

	Bargaining Authority April 16 ♦ Authorized removal of MVLF contingency ♦ Authorized 3-year economic package ♦ Conditioned all retirement enhancement on removal of the "trigger" in "Manager's Proposal" regarding CERS funding ratio - Retiree health - Increase in employee "pickups" - Increase in General Member formula (2.5% at 55) April 22 ♦ Authorized SSA's and other miscellaneous items all within the April 16 total economic authority ♦ Added 3 SSA's and requested more info on 3 others 4

The PowerPoint presentation included slides repeating the "Current Status" of Union Presidents employment and retirement benefits. Those slides (36-38) showed that MEA president Judie Italiano had been on a "Leave of Absence 14 years." It also repeated the Management Team's recommendation: "Authorize inclusion of union salary in high on[e] year calculation; establish a maximum retirement high one-year salary at level equal to City Labor Relations Manager (approximately $108,000 currently)."[95]

The 6 May 2002 Closed Session PowerPoint contained new terms of a proposal for the Firefighter Union President Ron Saathoff. The Management Team's recommendation was to "allow the current Local 145 President to begin Presidential

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[95] 6 May 2002 PowerPoint presentation for Closed Session City Council meeting regarding Meet and Confer issues (Slides 36-38). (Exhibit 57)

Leave under the terms described in Issue 2 effective July 1, 2002." The Management Team also recommended that Mr. Saathoff be allowed "contributions on union salary in addition to the City's contribution on Captain's salary, to a max of $108,000 for the one year period prior to July 1, 2002 to establish a high one year:"[96]

Meet & Confer 2002
Union Presidential Leave & Retirement Benefits
Issue 2: current Local 145 President

Management Team Recommendation:

1. Allow the current Local 145 President to begin a paid Presidential Leave under the terms described in Issue 2 effective July 1, 2002
2. Allow contributions on union salary in addition to the city's contributions on Captain's salary, to a max of $108,000 for the one year period prior to July 1, 2002 to establish a high one year

39

[96] 6 May 2002 PowerPoint presentation for Closed Session City Council meeting regarding Meet and Confer issues (Slide 39). (Exhibit 57)

The Management Team made additional generous recommendations for prospective union presidents, which were described in Slide 40 of the 6 May 2002 PowerPoint presentation at the City Council's Closed Session Meet and Confer meeting:[97]

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	Meet & Confer 2002 Union Presidential Leave & Retirement Benefits Issue 3: Prospective Union Presidents Management Team Recommendations: 1. Authorize full-time City-paid union Presidential Leave for each of the 4 unions beginning July 1, 2002 2. Union President/employee to be paid for normal work period at the salary of their current class when become President; receive regular benefits for the class; with *no* overtime 3. Retirement benefits consistent with his/her classification and level of compensation 4. Union may compensate the union president for

[97] 6 May 2002 PowerPoint presentation for Closed Session City Council meeting regarding Meet and Confer issues (Slide 40). (Exhibit 57)

	services to the union outside the normal work period. Such compensation shall not affect or be a party of City compensation, nor affect or add to retirement benefits 40

Minutes from the 6 May 2002 Closed Session City Council Meet and Confer meeting shows that the "Presidential Leave Mgr's recommendation 9-0."[98] A 24 May 2002 memorandum from City Labor Relations Manager Daniel E. Kelley addressed to the Mayor and City Council included "the City's final three-year offer to the San Diego Police Officers Association" which explained in blunt terms that the Council was conditioning the granting of new retirement benefits on the pension board waiving the fiduciary protections for plan participants:

> Substantial benefit improvements granted by the City since the adoption of the 'City Manager's Retirement Proposal' dated July 23, 1996 (Manager's Proposal) have created additional un-funded liability to SDCERS that was not anticipated when the City agreed to the 'trigger' provisions.
>
> Significant improvements in benefits are contained in this three-year proposal. Consequently, the 'trigger' provisions must be adjusted as a condition of the City's three-year proposal, therefore, this three year proposal is contingent upon, and subject to, approval by the SDCERS Board of Trustees of an adjustment to the 'trigger' provisions contained in the Manager's Proposal ... .
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> ***

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98 6 May 2002 Closed Session Meeting Minutes. (Exhibit 57)

> In an endeavor to meet converging interests and time lines, the City agreed to benefit enhancements through labor negotiations which have impacts on retirement funding, and consequently these benefit enhancements were offered contingent upon successfully addressing the potential 'trigger' in the 1997 Manager's Proposal.[99]

By June 2002 the center of gravity for the pension funding crisis had shifted back to the pension board. The City Council's proposal to wipe out the trigger and balloon payment protection for plan beneficiaries ran into difficulties at the pension board because the board's outside counsel balked at passing on the proposed arrangement.

These developments were described in a 14 June 2002 memorandum from City Human Resources Director Cathy Lexin to the Mayor and Council:

> During the recently concluded meet and confer, the City Council approved a number of retirement benefit enhancements with a contingency feature. The contingency was tied to an affirmative vote by the San Diego City Employees Retirement System (SDCERS) Board of Administration related to (1) committing $25 million from FY2000 SDCERS investment earnings to pay for retiree health insurance, (2) using an existing SDCERS reserve to pay for negotiated increases in the amount the City 'picks up' of employee's retirement contributions, and (3) the City's contribution rates and funding status.

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[99] 24 May 2002 Memorandum from Daniel E. Kelley, Labor Relations Manager for the City of San Diego to the San Diego City Mayor and Council. (Exhibit 58)

We expect that the SDCERS Board will approve the first two items. The third item regarding the City's contribution rates and funding status of the system is the most complex of the issues and is currently under critical review by the SDCERS Board's outside fiduciary counsel and outside actuary.[100]

[100] 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 1. (Exhibit 2)

Ms. Lexin went on in her 14 June 2002 memorandum to remind the Mayor and Council that the City Manager had presented the City Council's plan to do away with the 82.3% trigger and balloon payment at a "conceptual presentation before the SDCERS Board at a special meeting held on 29 May 2002."[101] Ms. Lexin informed the Council that the SDCERS outside counsel was 'uncomfortable' expressing an opinion that approval of the City's proposal was "within the Board's reasonable discretion as fiduciaries of the system:"[102]

> The current 'rate stabilization plan' stipulates that the City's contribution rates, beginning FY 97 would increase a fixed 0.50% per year, which is less than the actuarially determined rate necessary to ensure stable funding of the system. The basis for prior fiduciary counsel condoning the original agreement to accept less than full actuarial contributions from the City, was the establishment of a reasonable funding ratio floor (82.3%), and the expectation of progress toward full funding pursuant to this plan. Currently fiduciary counsel is concerned that the City is requesting a further reduction to the funding ratio floor (from 82.3% to 75%) with no balancing aspect to the proposal, no quid pro quo.[103]

Ms. Lexin goes on to further remind the Mayor and Council of the precipitous drop in the retirement plan's funding ratio. She also explains to the Mayor and Council that the funding arrangements in the 1997 Manager's proposal proved to be an

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[101] 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 1. (Exhibit 2)

[102] 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

[103] 14 June 2002 Memorandum from San Diego City Human Resources

inadequate safeguard of the plan's funding ratio:

> It is clear that the current arrangement whereby the City's contribution rate increases by a fixed 0.50% per year will not accomplish full funding as contemplated in the plan. A through analysis needs to occur and a funding policy developed that is acceptable to the SDCERS Board as Trustees and the City as Plan Sponsor."[104]

Ms. Lexin then delivered the bad news: The SDCERS outside fiduciary counsel was not going to approve the Mayor's and Council's proposal to lower the trigger and eliminate the balloon payment:

Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

[104] 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

> We had hoped the SDCERS Board would accept our proposal to lower the funding ratio floor to 75% with a commitment from the City to bring forward a long term solution within the next year. It does not appear that the fiduciary counsel will support this request."[105]

Ms. Lexin suggested that the Mayor and Council sweeten the deal by "increasing the annual increase in City contribution from 0.50% per year to 1.00% per year beginning in FY05 (an approximate $2.5 million increase)."[106] Ms. Lexin supported her suggestion by citing City Auditor, who supported the new 1.00%-a-year proposal as "a means to avoid the potential triggering of the fully actuarial rate in FY04 (a $25 [M] impact."[107]

Ms. Lexin urged the Mayor and Council to back the 1.00% per year increased funding proposal in order to avoid having to make the balloon payment:

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[105] 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

[106] 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

[107] 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

> IF we do not make this offer, it is likely that the SDCERS Board will not approve the proposal based upon a negative report from their fiduciary counsel. It is also a possibility that the funding ratio calculated for year ending FY02 will fall below 82.3% and trigger the full actuarial rate in FY04.[108]

In no uncertain terms Ms. Lexin informed the Mayor and Council that the Meet and Confer benefits were a quid pro quo for a waiver of the trigger and balloon payment:

> If either the original or this proposal fails, the retirement benefit improvements in the labor agreements with MEA, Local 127 and Local 145 will not occur. MEA has indicated that they will not schedule their ratification vote until this matter is heard by the SDCERS Board, and they anticipate that without the 2.5% at age formula improvements in FY03, the 3-year MOU may fail a ratification vote, in which case we would be bargaining again with the MEA next spring.[109]

One member of the SDCERS Board, Richard Vortmann, expressed objections over being put in the "middle of labor negotiations:"

> Given everyone's (on the Board, Counsel, Actuary) feeling the Board

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[108] 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

[109] 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

should not be put in the middle of labor negotiations, particularly when we now become the 'go-no go,' ... ."[110]

[110] 24 June 2002 Letter from Richard Vortmann to SDCERS Board Members and Administrators. (Exhibit 59)

Mr. Vortmann also asked for a clear statement from the City officials about "why they feel it is necessary to violate their previous '96 agreement."[111] Mr. Vortmann next asked the obvious question: "What is so compelling to violate the '96 safeguard? Is not that why the safeguard was part of the '96 deal?"[112] Mr. Vortmann then put his finger on the issue that the Mayor and Council were unwilling to face:

> The problem is very simply that the City does not want to pay currently for what they want to give the employees. They clearly are addicted to the 'give now, pay later' or 'burden the future years's taxpayers' when they no longer have any say in the decision - i.e. the decision being locked down now, with the mandatory bill being paid later.
>
> Since the City is in essence asking the Board to be an 'enable' to the City in their 'addition,' the Board at least deserves to hear everybody enunciate the truth – not a bunch of smoke about tough economic times, the State is screwing us, etc.[113]

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[111] 24 June 2002 Letter from Richard Vortmann to SDCERS Board Members and Administrators. (Exhibit 59)

[112] 24 June 2002 Letter from Richard Vortmann to SDCERS Board Members and Administrators. (Exhibit 59)

[113] 24 June 2002 Letter from Richard Vortmann to SDCERS Board Members and Administrators. (Exhibit 59)

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F. CITY COUNCIL SWEETENS THE DEAL

On 3 July 2002, San Diego Deputy City Manager Bruce Herring sent a memorandum to SDCERS administrator Lawrence Grissom which extended a modified version of the proposal described in Ms. Lexin's 14 June 2002 memorandum to the Mayor and Council.

Mr. Herring described the proposal to Mr. Grissom in a 3 July 2002 memorandum:

> This proposed modification would increase the City's agreed to rate by 1.00% beginning in FY05, projecting to reach the PUC actuarial rate by FY09, then continuing with 0.50% annual increases, but no less than the PUC rate, until the EAN rate is achieved.
>
> It is also proposed that the funded ratio floor be amended to 75% from 82.3%, and if the floor is effectuated, the City would begin paying at a rate that would achieve full PUC actuarial rate within five years, but no later than FY09. Once at PUC, the City would continue with 0.50% increases until EAN rate is achieved.
>
> ***
>
> As indicated in our June 10 and June 18 reports, the cost of any new benefits which may be considered by the City in the future, would not be absorbed, but paid for in addition to the agreed to City rates.[114]

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[114] 3 July 2002 Memorandum from Bruce Herring to Lawrence Grissom re: "City's Proposal Regarding Contribution Rates and Reserves and Responses to Questions from SDCERS Trustees." (Exhibit 60)

On 8 July 2002 San Diego City Human Resource Director Cathy Lexin issued a memorandum to the Mayor and City Council with the latest information from the SDCERS Board about the Mayor's and Council's proposal to avoid the trigger and balloon payments. Ms. Lexin informed the Mayor and City Council that the SDCERS Board would likely require a further modification of the City's proposal. This modification eliminated "the request to lower the funded ratio floor," it included a "five year phase-in if the trigger (82.3% funded ratio) is effectuated."[115] Ms. Lexin urged the Council to approve the modification again with an eye toward avoiding the trigger and balloon payment put into place to protect plan beneficiaries:

> Given the importance of avoiding a immediate full rate implementation (versus five year phase in), it is recommended that the Council authorize staff to agree to this modification should the proposal currently before SDCERS not prevail. [116]

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[115] 8 July 2002 Memorandum from Cathy Lexin to the Mayor and City Council re: "Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS," p. 2. (Exhibit 61)

[116] 8 July 2002 Memorandum from Cathy Lexin to the Mayor and City Council re:"Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS." p. 2. (Exhibit 61)

Ms. Lexin informed the Council of the need to act because the SDCERS Board had scheduled a special meeting for Thursday, 11 July 2002, to consider the Mayor and Council proposal.[117] The minutes for the City Council's Closed Session on 9 July 2002, held the day after Ms. Lexin's memorandum to the Mayor and Council, indicate that the Council approved additional modifications to their proposal to avoid the trigger and balloon payment. The minutes read:

> Authorize[d] modification of proposal-leave trigger at 82% of funding but 1 year grace period to pay (retirement formula), but only as back-up if original proposal (75% trigger) fails at Retirement Board."

This change was approved by a vote of nine (9) in favor, none opposed.[118]

On 11 July 2002 the SDCERS Board approved the modified version described in Ms. Lexin's 8 July 2002 memorandum to the Council. The motion passed 9-2 with one abstention. Mr. Vortmann and Ms. Shipione had departed the meeting prior to

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[117] 8 July 2002 Memorandum from Cathy Lexin to the Mayor and City Council re:"Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS." (Exhibit 61)

[118] 9 July 2002 Closed Session Meeting Minutes for the San Diego City Council. (Exhibit 62)

the vote.[119]

On 18 November 2002 the City Council approved the modification passed by SDCERS:

[119] 11 July 2002 Minutes SDCERS Board Meeting. (Exhibit 63)

> On July 11, 2002, the Board approved modifications to the Manager's Proposal. This Agreement is entered into in order to provide a transition period for City contributions to be brought, by Fiscal Year 2009, to the full contribution rates that would be applied if the projected unit credit funding method were used to provide accelerated contributions by the City if SDCERS funding ratio goes below 82.3% before the end of the term of this Agreement, and to terminate all transition arrangements regarding contributions with the City at the end of the Fiscal Year 2009.[120]

The Presidential Benefit was approved by the Council and Mayor on 21 October 2001 as Item-53.[121] The other benefits and increases in wages were

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[120] Minutes of the Council of the City of San Diego for the Regular Meeting of Monday, November 18 p.39-40 (ITEM-133: Two actions related to Approval of Agreements on SDCERS Board Indemnification & City SDCERS Employer Contributions.") (Exhibit 64)

[121] Minutes of the Council of the City of San Diego for the Regular Meeting of Monday, October 21, 2002 p.9 (ITEM-53: Approval of Ordinance amending the San Diego Municipal Code related to FY 2003 Negotiated Retirement Benefit Enhancements. (Exhibit 65)

approved by the Council on 18 November 2002.[122] The Mayor and Council granted substantial benefit increases including general salary increases and an 11% per year increase in pensions for general members, and special retirement benefits for the incumbent presidents of the MEA, POA, and Firefighters' unions.

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[122] Minutes of the Council of the City of San Diego for the Regular Meeting of Monday, November 18 p.8-10 (ITEMS-50 and 51: Approval of Ordinances amending the San Diego Municipal Code related to FY 2003 Negotiated Retirement Benefit Enhancements.) (Exhibit 66)

On 21 October 2002, the Council unanimously approved the introduction of the ordinance containing the retirement benefit increases negotiated in the 2002 meet and confer process.[123] The Presidential Benefit was passed by Council Resolution Number 297212 that same day. When the ordinance received its second reading on 18 November 2002, it was approved by an 8-1 vote, with Councilmember Frye voting against it.[124] The Presidential Benefit was passed by Council Resolution Number 297212 that same day. When the ordinance received its second reading on 18 November 2002, it was approved by an 8-1 vote, with Councilmember Frye voting against it.

III.

FAILURE TO COMPLY WITH REQUIRED FEDERAL SECURITIES LAW

A. THE DUTY TO DISCLOSE MATERIAL FACTS

Securities & Exchange Rule 10(b)5 prohibits the making of material false statements and the omission of facts needed to make statements not misleading:

Rule 10b-5 -- Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of

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123 Ordinance No. 19121.

124 Minutes of 18 November 2002 Council Meeting. (Exhibits 64, 66)

any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a. To employ any device, scheme, or artifice to defraud,
b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[125] [emphasis added]

The Securities & Exchange Commission has brought enforcement cases against public officials and public bodies relying upon Rule 10(b)5 and other antifraud provisions of federal securities law. Enforcement actions have been brought against officials in Miami, Florida *(In the Matter of the City of Miami, Florida, Cesar Odio and Manohar Surana*, Securities Act Release No. 7741, Exchange Act Release No. 41896, A.P. File No. 3-10022).

The City's outside counsel, as early as November 2003, spotted the SEC enforcement case against Miami as having at least some application to San Diego. On 26 November 2003 Paul Maco, the City's outside legal counsel, informed auditor Terri Webster that an SEC enforcement action against the City of Miami found that disclosures like those included in the City of San Diego's financial statement footnotes

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[125] 13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951. (Exhibit 67)

could be the basis of a fraud violation:

> Miami case – related to CAFR footnote misleading disclosure – found footnote to be fraudulent. In ruling we get the message:
> * Even though something is immaterial per GAAP it can still be in violation of anti-fraud law.
>
> Paul M. can see how Paul W. could find these error material due to (1) quantity (2) the big error on leases (3) lack of solid processes on City & CJO that didn't catch this stuff – loose [sic] credibility[126]

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[126] Handwritten notes by Terri Webster dated 11/26/03. (Exhibit 68)

Another critical case involved Orange County. *In re County of Orange, California; Orange County Flood Control District and County of Orange, California Board of Supervisors*, Securities Act Release No. 7260, Exchange Act Release No. 36760, A.P. File No. 3-8937 (January 24, 1996), *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors*, Exchange Act Release No. 36761 (January 24, 1996); *SEC v. Robert L. Citron and Matthew R. Raabe*, Civ. Action No. SACV 96-74 GLT (C.D. Cal.), Litigation Release No. 14792 (January 24, 1996) (complaint), *SEC v. Robert L. Citron and Matthew R. Raabe*, Litigation Release No. 14913 (May 17, 1996) (settled final orders). As detailed below, the application of the SEC enforcement action against Orange County officials was brought to the attention of San Diego City officials. City of San Diego officials, the Mayor and Council were told they could "not authorize disclosure that the official knows to be false" nor could they "authorize disclosure while recklessly disregarding facts."[127] [emphasis added]

Other relevant cases brought by the SEC against public entities and officials include the Boston cases (*In the Matter of the Massachusetts Turnpike Authority and James J. Kerasiotes*, Securities Act Release No. 8260, A.P. File No. 3-11198 (July 31, 2003); *SEC v. Robert D. Gersh, Boston Municipal Securities, Inc., and*

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[127] 6 November 2001 Closed Session Minutes. (Exhibit 69)

Devonshire Escrow and Transfer Corp., Civ. Action No. 95-12580 (RCL) (D. Mass.), Litigation Release No. 14742 (November 30, 1995) (complaint); *SEC v. Robert D. Gersh, Boston Municipal Securities, Inc., and Devonshire Escrow and Transfer Corp.*, Litigation Release No. 15310 (March 31, 1997) (settled final order); the Pennsylvania case (Injunctive proceedings *SEC v. David W. McConnell*, Civ. Action No. 00CV-2261 (E.D. Penn.), Litigation Release No. 16534, AAE Release No. 1254 (May 2, 2000); the San Antonio case, *SEC v. San Antonio Municipal Utility District No. 1, et al.*, Civ. Action No. H-77-1868 (S.D. Tex.), Litigation Release No. 8195 (November 18, 1977) (settled final order); the State of Washington cases, *SEC v. Whatcom County Water District No. 13, et al.*, Civ. Action No. C77-103, (W.D. Wash.), Litigation Release No. 7810 (March 7, 1977) (complaint); *SEC v. Whatcom County Water District No. 13, et al.*, **Litigation Release No. 7592 (May 10, 1977) (settled final order)**; *SEC v. Washington County Utility District, et al.*, Civ. Action No. 2-77-15 (E.D. Tenn.), Litigation Release No. 7782 (February 15, 1977) (complaint), *SEC v. Washington County Utility District, et al.*, Litigation Release No. 7868 (April 14, 1977) (default entered).

Additional cases have been brought by the SEC: *SEC v. Reclamation District No. 2090, et al.*, Civ. Action No. 76-1231-SAW (N.D. Cal.), Litigation Release No. 7460 (June 22, 1976) (complaint); *SEC v. Reclamation District No. 2090, et al.*, Litigation Release No. 7551 (September 8, 1976) (settled final order); *In re Newport-*

Mesa Unified School District, Securities Act Release No. 7589, A. P. File No. 3-9738 (September 29, 1998); *In re City of Moorhead, Mississippi*, Securities Act Release No. 7585, Exchange Act Release No. 40478, A.P. File No. 3-9724 (September 24, 1998); Securities Act Release No. 7616, Exchange Act Release No. 40770, A.P. File No. 3-9724 (December 10, 1998); *In re City of Carthage, MS., et al.*, Securities Act Release No. 40194, A. P. File No. 3-9650 (July 13, 1998) (administrative cease and desist proceedings against 38 municipalities and settled administrative orders); *In re County of Nevada, City of Ione, Wasco Public Financing Authority, Virginia Horler and William McKay*, Securities Act Release No. 7503, Exchange Act Release No. 39612, A.P. File No. 3-9542 (February 2, 1998).

Additional cases brought by the SEC against government bodies and public officials include: *In re County of Nevada*, Securities Act Release No. 7535, A.P. File No. 3-9542 (May 5, 1998); *In re Wasco Public Financing Authority*, Securities Act Release No. 7536, A.P. File No. 3-9542 (May 5, 1998); *In re City of Ione*, Securities Act Release No. 7537, A.P. File No. 3-9542 (May 5, 1998); *In re City of Syracuse, New York, Warren D. Simpson, and Edward D. Polgreen*, Securities Act Release No. 7460, Exchange Act Release No. 39149, AAE Release No. 970, A.P. File No. 3-9452 (September 30, 1997); *In re Maricopa County*, Securities Act Release No. 7345, Exchange Act Release No. 37748, A.P. File No. 3-9118 (September 30, 1996); *In re*

Maricopa County, Securities Act Release No. 7354, Exchange Act Release No. 37779, A.P. File No. 3-9118 (October 3, 1996).

Cases that have focused on public officials brought by the SEC also include: *SEC v. Larry K. O'Dell*, Civ. Action No. 98-948-CIV-ORL-18A (M.D. Fla.), Litigation Release No. 15858 (August 24, 1998) (settled final order).

B. MATERIALITY

The United States Supreme Court has found that for information to be material "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." [emphasis added] *TCS Industries, Inc. v. Northway, Inc.,* 426 U.S. 438, 449 I1976).

For financial statements misstatements or omissions of facts needed to make those statements not misleading are material when:

> [T]he magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.[128]

In addition to the Rule 10(b)5 prohibitions, Exchange Act Rule 15c2-12 prohibits the underwriting of municipal securities unless the underwriters have

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[128] Statement on Auditing Standard no 47, Audit Risk and Materiality in Conducting an Audit (AU § 312.10). (Exhibit 70)

reasonably determined that the issuers for whom they are providing underwriting services have undertaken to provide the marketplace with certain required on-going information.[129] The participating underwriter must determine that the contractual undertaking "meets the standards of the rule."[130]

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[129] Exchange Act Release No. 34,961 (Nov. 10, 1994).

[130] Fippinger, Robert A. *The Securities Law of Public Finance* § 6:5.1 (6-42).

Rule 15c2-12 creates a duty to "update annually the financial information and operating data that are set forth in the final official statement."[131] The anti-fraud provisions should be viewed as the standard of care for the preparation of the annual disclosures required by Rule 15c2-12."[132] When a municipal issuer "releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions."[133]

The City of San Diego's outside legal counsel determined that the following information about the City of San Diego's financial statement was material and should be disclosed. This information was not previously disclosed until the City, acting on

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131 Fippinger, Robert A. *The Securities Law of Public Finance* § 6:5.1 (6-42).

132 Fippinger, Robert A. *The Securities Law of Public Finance* § 6:5.2 (6-44)

133 Fippinger, Robert A. *The Securities Law of Public Finance* § 6:5.2 (6-45); Release No. 33-7049 (9 March 1994).

the advice of the City's outside bond counsel Paul Weber, disclosed it on 27 January 2004 in a special filing with the various municipal disclosure depositories[134]:

> Mr. Webber believed that the basic information that should be disclosed was: (1) the City's currently required payment amounts, (2) the amount that the City is paying, per collective bargaining agreements, of its employees' share of their currently required contributions, and (3) the amount of supplemental benefits paid from Plan Assets, thus increasing the UAAL. Other information he thought should be conveyed included methodologies used in calculating UAAL, such as amortization periods, and key assumptions, such as investment returns.

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[134] Since 1990, underwriters of municipal securities have filed the official statement or offering document, for most municipal securities offerings, with the MSRB's Municipal Securities Information Library.

> Finally, information about responsibility for payment for health care benefits and how they are being funded should, in his view, be disclosed. Mr. Webber viewed the obligation to fund these different benefits as similar to the obligation to pay a debt and, while future debt payments are typically sums certain, and projections regarding the categories described above are not, he believed that "order of magnitude" disclosures could be made to give the prospective investor a general sense of the City's obligations. Mr. Webber believed that the City had a duty to estimate and disclose its anticipated obligations over a reasonable period into the future.[135]

In addition to failing to make these disclosures until the voluntary filing on 27 January 2004 the City misstated that its "corridor" funding method was "excellent" when in fact had a long-standing practice of reducing employer and employee contributions to its pension plan thus pushing the liability onto future generations of city employees and taxpayers. The City adopted prolonged amortization schedules and used creative accounting practices, such as adopting a method for computing the unfunded liability (the PUC method) that allowed the City under report the amounts due from the City to the pension plan.

Investors should also have been told about the trigger and balloon payments and about the questionable device of paying increased and special benefits to those on the

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[135] 16 September 2004 Report on Investigation, The City of San Diego, California's Disclosure of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004, pg. 117. (Exhibit 71)

pension board in exchange for an agreement to violate the fiduciary law protecting beneficiaries. The California State Constitution sets forth the basic fiduciary duty that was violated by the Council and Pension Board:

> (a) The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.
>
> (b) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty.
>
> (c) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.[136]

As stated in the Constitution, the Board must act "with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a

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[136] California Constitution Article 16 Public Finance § 17. (Exhibit 18)

like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims." Generally, prudent action requires that all relevant facts be examined and evaluated before a decision is made. Decisions must be made in light of the board's goals and responsibilities. The one over-riding goal of the SDCERS Board should be to protect the public funds placed in its care. In reviewing the duty of a retirement board, one court observed that the board had a "constitutional mandate to place the needs of the retirement's fund's participants and their beneficiaries above all other duties, and ... to insure the financial integrity of the assets in its care." *Corcoran v. Contra Costa County Employees Retirement Board*, 60 Cal.App.4th 89, 94 (1997). Protection of the fund's assets, therefore, should have always been, and should always be, the over-arching goal and responsibility of the SDCERS Board.

In order to avoid the trigger and balloon payment, the Mayor and Council granted general and special benefits to pension board members to induce the board members to waive the trigger and allow the City to escape the balloon payments. Upon these premises, the San Diego City Attorney finds there is substantial evidence consistent with a finding that pension board members failed to hold the funds and assets of the City pension fund "for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries in violation of California State Constitution Article 16 § 17(a). These actions were not consistent

with the duties imposed upon the City by the 23 July 1996 agreement. The City failed to live up to its commitment to keep the funded ratio at 82.3% and pension board members joined in that failure.[137] With the City failing to contribute the funds needed to keep the pension plan funding ratio at 82.3% it plunged to 65% as of 2004.[138]

As outlined, the Board was under a constitutional mandate "to place the needs of the retirement's fund's participants and their beneficiaries above all other duties, and thus insure the financial integrity of the assets in its care." *Corcoran v. Contra Costa County Employees Retirement Board,* 60 Cal.App.4th 89, 94 (1997). By choosing to allow the plan's funding ratio to fall below the floor agreed to in Manager's Proposal I, the Board breached its fiduciary duty to the City and the plan participants to protect the fund's assets.

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[137] The impact of the trigger mechanism was interpreted by SDCERS outside fiduciary counsel, as well as by Mr. Maco, as requiring the City to maintain the funded ratio at 82.3%. V&E Report, page 83.

[138] San Diego City Employees Retirement System 2004 Actuarial Report for as of 30 June 2004.

The City's duty to keep the plan at the 82.3% funding ratio which would required the City to contribute over $500 million to the pension plan was acknowledged by the plan's fiduciary counsel, board member Ron Saathoff, and the plan's actuary.[139] The City Auditor and the plan's administrator misinformed the Council that the balloon payment was $25 million.[140]

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[139] 21 June 2002 Minutes of the SDCERS Board Meeting pp. 16-17. (Exhibit 72)

[140] See Meet and Confer Section of this Report, pg. 30, *et seq.*

Investors were kept in the dark about the trigger and balloon payment to the pension plan. They were not timely informed that the plan's funded ratio was crashing. City auditor Webster acknowledged that the funding ratio was a "fiscal indicator of the health" of the CERS fund which was a major fund of the City.[141] She knew "[a] large drop in funding ratio or dropping below certain benchmarks could result in a negative impact to the City's credit rating." A lower bond rating, according to Ms. Webster, was "vital to keep borrowing costs down for future issuances on the horizon such as for fire stations, main library, and branch libraries, etc."[142]

The City should have disclosed that the payment of retiree health care benefits with pension funds, the allowing of non-participant union employers to participate in the plan, and the payment of special benefits to union presidents in exchange for their agreement to violate or aid in the violation of fiduciary obligations threatened the tax exempt status of the pension plan.[143] The City should have informed investors that pension plan participants were granted the right to buy pension credits at deep discounts when there was no identified funding source. Investors also should have

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[141] 18 March 2002 Email from Terri Webster to Rgarnica@unitedcalbank.com on the subject of CERS. (Exhibit 13)

[142] 18 March 2002 Email from Terri Webster to Rgarnica@unitedcalbank.com on the subject of CERS. (Exhibit 13)

[143] 29 October 2004 Memorandum from Plan Administrator Lawrence Grissom to City Manager Lamont Ewell. (Exhibit 54)

been told that the City had granted pension benefits retroactively without providing a funding source.

The City should not have falsely represented in financial statement documents used in later bond offering documents that:

> The actuary believes the Corridor funding method is an excellent method for the City and that it will be superior to the PUC funding method. The actuary is in the process of requesting the GASB to adopt the Corridor funding method as an approved expending method which would then eliminate any reported NPO.[144]

C. THE CITY COUNCIL WAS TOLD OF ITS DISCLOSURE DUTIES

City officials who issue investment bonds "have ultimate authority to approve the issuance of securities and related disclosure documents have responsibilities under the federal securities laws as well."[145]

On 6 November 2001 the Mayor and City Council, in writing and orally during a briefing by its outside securities law experts, were informed of their duties under the federal securities law.[146] The Mayor and City Council were reminded that the County

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[144] See, 5 September 2003 Email from Diann Shipione to Plan Administrator documenting that the false statement was included in the August 2002 Wastewater $505 million bond offering (Exhibit 73); 6 February 2001 SDCERS Business & Procedures Minutes p. 4 (Exhibit 74).

[145] *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors*, Exchange Act Release No. 36761 (January 24, 1996). (Exhibit 75)

[146] 6 November 2001 Closed Session Minutes. (Exhibit 69)

Board of Supervisors in neighboring Orange County had been found to have violated federal securities laws in connection with bond offerings in 1996.

The federal securities law standard under which the Mayor and Council were to conform their conduct was provided in writing:

> In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.[147]

Despite the clear duty to disclose the material facts about both the trigger and balloon payment and the financial condition of the pension and its impact on the City's overall financial condition, the council failed to take reasonable steps to ensure proper disclosure in the following City bond offerings:[148]

1.
29 April 2002
$25,070,000

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147 6 November 2001 Closed Session Minutes. (Exhibit 69)

148 The beginning date of 18 March 2002 marks the date that the Mayor and Council were provided a PowerPoint presentation showing the actuarial funding ratio had dropped to 89.9%.

Public Facilities Financing Authority of the City of San Diego
Lease Revenue Bonds Series 2002 B
(Fire and Life Safety Facilities Project)
Ordinance No. O-19054 - Adopted April 29, 2002
Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

2.
14 May 2002
$93,200,000
City of San Diego, California
2002-03 Tax Anticipation Notes Series A
3.00% Interest Rate @ 101.382% Price to Yield 1.70%
Resolution No. R-296500 - Adopted May 14, 2002
Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

3.
16 September 2002
16 September 2002
$286,945,000
Public Facilities Financing Authority of the City of San Diego
Subordinated Water Revenue Bonds, Series 2002
(Payable Solely From Subordinated Installment Payments Secured by Net System Revenues of the Water Utility Fund)
Resolution No. R-297070 - Adopted September 16, 2002
Districts 1, 2, 3, 4, 6, 7, 8, and Mayor - Yea
District 5 - Not Present

4.
3 March 2003
$15,255,000
City of San Diego/MTDB Authority
2003 Lease Revenue Refunding Bonds
(San Diego Old Town Light Rail Transit Extension Refunding)
R-297693 - Adopted March 3, 2003
Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

5.
3 March 2003
$17,425,000

City of San Diego
2003 Certificates of Participation
(1993 Balboa Park/Mission Bay Park Refunding)
Evidencing Undivided Proportionate Interests in Lease Payments to be
Made by the City of San Diego Pursuant to a Lease with the
San Diego Facilities and Equipment Leasing Corporation
Resolution No. R-297692 - Adopted March 3, 2003
Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

6.
20 May 2003
2003-04 Tax Anticipation Notes Series A
$110,900,000
City of San Diego, California
1.75% Interest Rate @ 100.939% Price to Yield .800%
Resolution No. R-297969 - Adopted May 20, 2003
Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

7.
30 June 2003
$505,550,000
Public Facilities Financing Authority of the City of San Diego
Surbordinated Sewer Revenue Bonds, Series 2003A and Series 2003B
(Payable Solely From Subordinated Installment Payments Secured by Wastewater System Net Revenues
Resolution No. R-298133 - Adopted June 30, 2003
Districts 1, 2, 3, 4, 5, 6, 7, and Mayor - Yea
District 8 - Not Present [149]

IV.

CONCLUSION

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[149] See Chart of Bond Offerings from 29 April 2002 to 30 June 2003. (Exhibit 77)

Based upon these premises, the San Diego City Attorney concludes that there is substantial evidence consistent with a finding that the Mayor and Council authorized the issuance of City bond offering and related disclosure documents, identified above, that the Mayor and City Council Members knew to be false, as set forth above.

Moreover, the San Diego City Attorney concludes that there is substantial evidence consistent with a finding that the Mayor and Council authorized bond offering documents and related disclosure offering documents, for the bond offerings identified above, while they recklessly disregarded facts indicating a risk that the disclosures might be misleading, as set forth above.

The San Diego City Attorney further concludes that there is substantial evidence consistent with a finding that the Mayor and Council had knowledge of facts set forth herein that brought into question the City's ability to repay the bonds sold by the City of San Diego, identified above. The City Attorney of San Diego finds that under these circumstances there is substantial evidence supporting a finding that it was reckless for the Mayor and City Council, with regard to the bond offerings identified above, to approve the related disclosures to investors without taking steps to prevent the dissemination of materially false or misleading information regarding those bonds. In this matter, such steps should have included becoming familiar with the disclosure documents and questioning the City's officials, employees, or other agents about the

disclosure of the material facts.[150]

Upon these premises the San Diego City Attorney concludes that there is substantial evidence consistent with a finding that the Mayor and City Council engaged in civil violations of federal securities laws. There is no finding of any wrongdoing by Council Member Tony Young. He was not elected to represent the Fourth Council District until 4 January 2005 and therefore there is no evidence of his involvement in any of the alleged securities law violations.

There is no finding of any wrongdoing by Council Member Michael Zucchet. He did not take office until 2 December 2002. He was not a Council Member during the period of time in which the information about the trigger and balloon payment was provided to the Council. On 3 December 2002 Mr. Zucchet did vote in favor of Item-50 (Ordinance O-2003-67), which granted Fire Fighters Local 145 members additional benefits. Those benefits consisted of (1) allowing Fire Fighters Local 145 members to "convert Annual Leave accrued after July 1, 2002 to service credit in SDCERS or extend their participation in the System's Deferred Retirement Option Plan ("DROP");" and (2) allowing the purchase of creditable service to apply towards the ten year vesting requirement. Mr. Zucchet also voted to approve municipal bond disclosure documents for some offerings. There is no finding of wrongdoing by Mr.

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[150] 6 November 2001 Closed Session Minutes. (Exhibit 69)

Zucchet.

The remaining council members fall along a continuum. The Mayor and Council Member Scott Peters have the most relevant training for understanding the underlying complex facts and circumstances. Both are Phi Beta Kappa graduates with economic degrees. Mayor Murphy holds a Masters of Business Administration Degree from the Harvard Business School. Council Member Peters is a graduate of Duke University. Mayor Murphy has a law degree from Stanford University; Council Member Peters has a law degree from New York University.

Mayor Murphy was an associate in the law firm of Luce, Forward, Hamilton & Scripps. Council Member Peters was an associate at the firm of Baker & McKenzie. Mayor Murphy served as a Municipal and Superior Court Judge for 15 years. He was admitted to practice 16 December 1975. Mr. Peters had considerably less experience than Mayor Murphy, having practiced in the field of environmental law before his election to the Council in December 2000. He was admitted to practice in California on 6 June 1989.

At the other end of spectrum is Council Member Donna Frye. Council Member Frye has no advanced degrees in business or law. She has no expert training in law or business. Although she voted in earlier Closed Sessions to extend more benefits and to continue the underfunding she was the only council member to vote against extending those benefits when it went to a later public vote. She also voted against the ballpark

bonds offering documents.

Council Member Toni Atkins also has no expert training in law or business. However, Ms. Atkins voted to underfund the pension system and to exchange benefits for a waiver of the trigger and balloon payments.

Between these two points stand Council Members Brian Maienschein, Jim Madaffer, and Ralph Inzunza. Council Member Maienschein is an attorney but he had a community based practice. Council Members Madaffer and Inzunza have no relevant expert training. Council Member Madaffer attended Grossmont College and San Diego State University. Council Member Inzunza is a graduate of San Diego State University but his area of expertise is Latin American Studies.

Two former Council persons participated in the matters addressed in this report. They are former Council Members Byron Wear and George Stevens. Neither of these Council Members had expert training in law or business.

KPMG has cited to the conclusion reached in the 16 September 2004 report of the City's outside counsel that "any attempt to conceal the SDCERS funding situation would have been an 'exercise in futility.'"[151] The San Diego City Attorney concludes in this Second Interim Report that there is substantial evidence consistent with a finding that the Mayor and City Council did attempt to conceal and did conceal the

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[151] 11 October 2004 and 29 October 2004 KPMG letters to San Diego Assistant City Attorney re: City of San Diego Fiscal Year 2003 Audit. (Exhibit 76)

granting of pension benefits in exchange for the waiver of the trigger and balloon payments. The City Attorney of San Diego further concludes that there is substantial evidence consistent with a finding that the Mayor and City Council concealed the other aspects of the underfunding, trigger, balloon payments, wrongful accounting and funding practices as set forth in this report. Finally, the San Diego City Attorney concludes that there is substantial evidence consistent with a finding that the Mayor and City Council engaged in the alleged wrongful conduct either knowingly or recklessly.

The San Diego City Attorney has investigated the issues raised by KPMG in their correspondence of 11 October 2004 and 29 October 2004 and related writings. This investigation has been conducted to resolve the federal securities law issues raised in those writings. Additional City Attorney reports will address other possible illegal acts and other responsible parties, if and when requested by KPMG.

Finally, it should be stressed that much of the evidence set forth in this report was made available to the investigation only because the Mayor and

/ / /

Council made the honorable decision to waive the confidentiality privileges held by the City. They did this knowing that it would put them at risk.

MICHAEL J. AGUIRRE, City Attorney

By _____
Michael J. Aguirre
City Attorney

EXHIBIT 44

TRANSCRIPT OF 8 AUGUST 2006 PRESS CONFERENCE:

LEVITT
We stand ready to be helpful in any way that we can.

I think the City Attorney made himself largely irrelevant by his outburst this morning. I think that there is a reasonable approach on the part of the Council and the mayor. And there are limited number of solutions to the problem. They are obvious, they are plain. The City Attorney focused on sidebar issues, which is his particular issue. But it is a side bar, and it's not fundamental.
The issue we were here to discuss today and we were retained to execute was to get KPMG to complete their audits so you can you can get one with restoring the City.
And I think progress was made in that direction.
I think that if the Council and the Mayor keep their focus on that and they are not diverted by the antics of the City Attorney, I think will be well served.

Pension Obligation Bonds
I believe that that this not the appropriate priority for the City right now. The first step should be to try to determine a long term and even a short term financial plan...Pension obligation bonds, selling at the yields that you would have to offer them at today, would not be advantageous to the City and it would be costly to the taxpayer.

TURNER
Take a look at whatever it needs to do to balance the budget.

ROMANO
There is also no recommendation that you keep benefits. There is a discussion of the legal issue of whether benefits can and should, can be rolled back legally.
We come to the conclusion that it's more likely than not that they cannot be rolled back legally. But we don't recommend that they be maintained. We just address it as a legal issue.

LEVITT
The magnitude of the problem is significant. There are a limited number of solutions. Obviously cuts on the one hand, taxes on the other hand are among a very limited number of solutions. We are certainly not prepared, nor will we, make those recommendations. That's for the various parties in the City to work out among themselves.

By raiding the pension fund, they exacerbated the problem. So, now the City has got to straighten it out and they straighten it out by telling it like it is. By adequate disclosure.

ROMANO
Negligence is a standard that in Orange County the Securities and Exchange Commission stated applied to elected officials. Elected officials have a responsibility to exercise care, be careful, in reviewing disclosure documents that they are authorizing. That was issued in 1996. It really means that we expect out elected officials to act more carefully.

...It's not possible to quantify it. The way these matters are generally addressed in court and legal proceedings is, you look at the conduct of the person you are interested in; you compare it, if there is an industry standard, you might look at that; you use a variety of way to judge how these persons should act.
We don't have to go that far because in 1996 the SEC said that elected officials have to exercise reasonable care.

We identify them by name in the report, so I want you to be careful to look at the report so we know who we are talking about.
We conclude that they acted negligently in that they did not exercise reasonable care in authorizing the disclosure documents. Ordinarily, that does not constitute a violation of the anti-fraud provisions because anti-fraud, under the securities laws, requires a more culpable or bad state of mind. It requires something that we in the legal business call scienter, or wrongful purpose. It is more than carelessness. It is more serious than sloppiness or indifference. A person with scienter, is a person who acts and knows that what they are doing is probably wrong and proceeds anyway. We did not conclude the City Council members had that state of mind when they authorized the public disclosures when they did....

Negligence in certain standards, I should tell you the SEC has never to our knowledge, brought an action for negligence against an elected official. They have against City employees. In the city of Miami. In Mass Turnpike, the chairman of...
They acted negligently in connection with the issuance of securities. Whether that constitutes a complete violation is something that the SEC will have to address.

We hope that they see that we were careful and that we review all, or substantially all, of the records that they viewed.

LEVITT
Ballpark bonds
I don't know that I would characterize the Council role particularly. But, obviously, it was the kind of public pressure to push things under the rug, to address the difficult issues in the interest of getting that ball0park built. That's bad decision making which came back to haunt the City.

Remediation
I think, clearly, the SEC will follow our report very closely. They will have their own recommendations which probably won't be dramatically different. I think the question is can they afford not to embrace the recommendations in remediation section.

Raided – City Managers
They knew that they were getting funds from the pension funds. They knew that, obviously, I don't' know what their state of mond is, obviously they like many city offcials all over city officials all over amercia have felt, the see a pot of money over there and they say this is the way that we can use it and the budget this year isn't going to reflect the problems. That always comes back to haunt you.

I'll leave to lawyers.

YOUNG
We do find that some people acted with wrongful intent. The report sets forth those that we believe acted with wrongful intent, those that were negligent, those that breached their fiduciary responsibilities. So, not everybody got away with negligence.

LEVITT
I would expect that this does end our work with the City. Except that if the Council has additional question, of course, as I said, we stand ready to respond to them.

EXHIBIT 45

Filed 9/7/07

CERTIFIED FOR PUBLICATION

COURT OF APPEAL - FOURTH APPELLATE DISTRICT

DIVISION ONE

STATE OF CALIFORNIA

CATHY LEXIN et al., Petitioners, v. THE SUPERIOR COURT OF SAN DIEGO COUNTY, Respondent; THE PEOPLE, Real Party in Interest.	D049251 (San Diego County Super. Ct. No. SCD190930)

Writ of prohibition following denial of petitioners' motion to set aside information. The Honorable Frederic L. Link and Roger W. Krauel, Judges. Petition denied.

Gibson, Dunn & Crutcher and Nicola T. Hanna for Petitioner Cathy Lexin.

Coughlan, Semmer & Lipman, R. J. Coughlan, Jr., and Earll M. Pott for Petitioner Ronald Lee Saathoff.

II. *SECTION 1090 AND ITS EXCEPTIONS*

Section 1090 provides in part:

> "Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members. Nor shall state, county, district, judicial district, and city officers or employees be purchasers at any sale or vendors at any purchase made by them in their official capacity."

Section 1090 codifies the common law prohibition against "self-dealing" with respect to contracts. (See Stats. 1851, ch. 136, § 1; *BreakZone Billiards v. City of Torrance* (2000) 81 Cal.App.4th 1205, 1230; *Stigall v. City of Taft* (1962) 58 Cal.2d 565, 571; *City of Oakland v. California Const. Co.* (1940) 15 Cal.2d 573, 576; *Stockton Plumbing & Supply Co. v. Wheeler* (1924) 68 Cal.App. 592, 597.) Conflict of interest laws such as section 1090 exist to ensure that the government's decisions are made in the public's best interest with out regard to potential personal financial gain:

> "The object of section 1090 of prohibiting individuals 'from being financially interested in any contract made by them in their official capacity or by the body or board of which they are members is to insure absolute loyalty and undivided allegiance to the best interest of the [government agency] they serve and to remove all direct and indirect influence of an interested officer as well as to discourage deliberate dishonesty. [Citations.]' [Citation.]" (*Thorpe v. Long Beach Community College District* (2000) 83 Cal.App.4th 655, 659.)

"The evil to be thwarted by section 1090 is easily identified: If a public official is pulled in one direction by his financial interest and in another direction by his official duties, his judgment cannot and should not be trusted, even if he attempts impartiality." (*Carson Redevelopment Agency v. Padilla* (2006) 140 Cal.App.4th 1323, 1330.) "'In our

society, people of ordinary sensibility should recognize, *without the intervention of a criminal proscription,* that a public official is a trustee and that it is wrong for such a trustee to engage in self-dealing, including the contingent feathering of one's own nest.' [Citation.]" (*People v. Chacon* (2007) 40 Cal.4th 558, 570, original italics.)

"[T]he prohibited act is the making of a contract in which the official has a financial interest." (*People v. Honig* (1996) 48 Cal.App.4th 289, 333 (*Honig*).) "Put in ordinary, but nonetheless precise, terms, an official has a financial interest in a contract if he might profit from it." (*Ibid.*; accord, *People v. Gnass* (2002) 101 Cal.App.4th 1271, 1288, fn. 6.)

Prohibited "financial interests" extend to expectations of economic benefit. (*Honig, supra,* 41 Cal.App.4th at p. 315.) "[A] financial interest within the meaning of section 1090 may be direct or indirect and includes the contingent possibility of monetary or proprietary benefits." (*Id.* at p. 325; see *People v. Vallerga* (1977) 67 Cal.App.3d 847, 865; *People v. Darby* (1952) 114 Cal.App.2d 412, 433, fn. 4.) "[F]orbidden financial interests may . . . involve financial losses, or the possibility of financial losses, as well as the prospect of pecuniary gain." (86 Ops.Cal.Atty.Gen. 138, 140 (2003).)[7] All the circumstances of the transaction as a whole must be considered in determining whether a

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7 Although courts are not bound by the California Attorney General's opinions, they are entitled to "'considerable weight.'" (*Thorpe v. Long Beach Community College Dist., supra,* 83 Cal.App.4th at p. 662.). "This is particularly true where, as here, the Attorney General regularly advises local agencies about conflicts of interest, and where, as here, no clear case authority exists on the question before us." (*People v. Gnass, supra,* 101 Cal.App.4th at p. 1304.)

proscribed financial interest would be present in the contract. (*Thomson v. Call* (1985) 38 Cal.3d 633, 644-645; *Honig, supra,* 48 Cal.App.4th at pp. 315, 320; *People v. Watson* (1971) 15 Cal.App.3d 28, 37; *People v. Darby, supra,* 114 Cal.App.2d at pp. 431-432.)

"In considering conflicts of interest [courts] cannot focus upon an isolated 'contract' and ignore the transaction as a whole." (*Honig, supra,* 48 Cal.App.4th at p. 320.) Courts "look[] past the individual contracts in question and consider[] the relationships between all the parties connected with them, either directly or indirectly, to determine if a conflict of interest existed." (*People v. Gnass, supra,* 101 Cal.App.4th at p. 1294; see also *Campagna v. City of Sanger* (1996) 42 Cal.App.4th 533, 541. Thus, courts should not be "concerned with the technical terms and rules applicable to the making of contracts, but instead [with] rules governing the conduct of governmental officials." (*Honig, supra,* 48 Cal.App.4th at p. 314.) "We must disregard the technical relationship of the parties and look behind the veil which enshrouds their activities in order to discern the vital facts. [Citation.] However devious and winding the trail may be which connects the officer with the forbidden contract, if it can be followed and the connection made, a conflict of interest is established." (*People v. Watson, supra,* 15 Cal.App.3d at p. 37.)

A. *A Reasonable Person Could Harbor a Strong Suspicion Petitioners' Actions Violated Section 1090*

While the MP2 contract between the City and SDCERS itself did not directly involve a financial interest relating to the defendants, we must look at the transaction as a whole. The allegation is, and the evidence presented at the preliminary hearing shows,

drawing every reasonable inference in favor of the information, a reasonable person could harbor a strong suspicion that enhanced benefits in which each defendant *did* have an interest were contingent upon SDCERS's approval of MP2. Because of the broad scope of section 1090, it matters not that petitioners were not parties to the contract between the City and the labor unions. "[S]ection 1090 applies even when a public official's financial interest flows from a source that is independent of a public contract." (*Carson Redevelopment Agency v. Padilla, supra,* 140 Cal.App.4th at p. 1334.) "The phrase 'financially interested' broadly encompasses anything that would tie a public official's fortunes to the existence of a public contract." (*Id.* at p. 1335.)

What is important under section 1090 is whether petitioners stood to gain something personally with respect to the contract between SDCERS and the City, a contract over which petitioners could exercise influence. As the court found on this issue, "the evidence contained in the preliminary hearing provides a rational ground for assuming the probability that on July 11, 2002, each of the [petitioners] proceeded to act on the City's proposal for a 75% trigger, knowing that an action by the Retirement Board could also satisfy the MOU Contingency Provision and thereby remove the condition on the [petitioners'] receiving their enhanced retirement benefits agreed to in the MOUs."

Further, it matters not, as petitioners claim, that at the time MP2 was actually signed, the contingencies in the MOU's were gone. Section 1090's broad scope encompasses "the planning, preliminary discussion, compromises, drawing of plans and specifications and solicitation of bids that led up to the formal making of the contract." (*Honig, supra,* 48 Cal.App.4th at p. 315; see also *Thomson v. Call, supra,* 38 Cal.3d at

pp. 644-645 [successive contracts were considered part of a single multiparty agreement for purposes of section 1090].) As we stated in *City Council v. McKinley* (1978) 80 Cal.App.3d 204, 212, "the negotiations, discussions, reasoning, planning, and give and take which go beforehand in the making of a decision to commit oneself must all be deemed to be a part of the making of an agreement in the broad sense [citation]. . . . If the date of final execution were the only time at which a conflict might occur, a city councilman could do all the work negotiating and effecting a final contract which would be available only to himself and then present the matter to the council, resigning his office immediately before the contract was executed. He would reap the benefit of his work without being on the council when the final act was completed. This is not the spirit nor the intent of the law which precludes an officer from involving himself in the making of a contract. The statutes are concerned with any interests, other than perhaps a remote or minimal interest, which would prevent the officials involved from exercising absolute loyalty and undivided allegiance to the best interests of the city [citation]."

Viewed in isolation, petitioners' mere presence at the May 29, June 21 and July 11 board meetings would not have been sufficient to support a section 1090 prosecution. Similarly, their vote taken on November 15, taken on its own, also might not support a section 1090 action as the contingencies in the MOU's had been removed by that time. However, "[i]n considering conflicts of interest [courts] cannot focus upon an isolated 'contract' and ignore the transaction as a whole." (*Honig, supra*, 48 Cal.App.4th at p. 320.)

Thus, we look at the continuing course of conduct from May 29 through November 15. If the evidence the People presented at the preliminary hearing arguably shows that (1) petitioners participated in the making of MP2, (2) they had a financial interest in that contract because increased pension benefits were contingent upon approval of MP2, and (3) they "made" a contract under section 1090 when they voted to approve MP2 on November 15 because they only voted to approve the contract because of the increase in retirement benefits, the People have stated a claim for violation of Government Code section 1090 sufficient to withstand a Penal Code section 995 motion to set aside the information.

The evidence presented at the preliminary hearing was that during the time period between May 29 and November 15 petitioners considered, discussed, and/or negotiated the various proposals at a time when enhanced pension benefits were contingent on their voting to approve contribution relief for the City. The entire course of conduct of petitioners' conduct shows that they participated in the making of a contract in which they had a financial interest. That course of conduct ended with the November 15 vote to provide the City with its requested contribution relief. Although the contingencies in the MOU's were formally removed from the MOU's when petitioners approved the MP2, there was sufficient evidence such that "a reasonable person could harbor a strong suspicion of the defendant's guilt" (*Cooley, supra,* 29 Cal.4th at p. 251.): i.e., that they would not have agreed to the contribution relief but for the City's agreement to increase retirement benefits. That evidence was sufficient to bind petitioners over for trial for a violation of section 1090.

The penalties for violation of section 1090 are stated in section 1097, which provides:

> "Every officer or person prohibited by the laws of this state from making or being interested in contracts, or from becoming a vendor or purchaser at sales, or from purchasing scrip, or other evidences of indebtedness, including any member of the governing board of a school district, who willfully violates any of the provisions of such laws, is punishable by a fine of not more than one thousand dollars ($1,000), or by imprisonment in the state prison, and is forever disqualified from holding any office in this state.

However, "[t]he harsh consequences of section 1090's prohibition are ameliorated in two different ways. First, section 1091.5, which describes certain 'noninterests,' where if applicable, the contract may be executed because the Legislature has determined that the particular interest is insufficient to merit application of the prohibition. In noninterest situations, the interest does not require the officer's abstention and generally does not require disclosure." (83 Ops.Cal.Atty.Gen. 246, 247 (2000).)

As we shall explain in the following sections, (1) while pension benefits come under the definition of "salary" under section 1091.5(a)(9), that exception to section 1090 is not applicable under the facts of this case; and (2) pension benefits are not "public services" under section 1091.5(a)(3).

B. *Section 1091.5(a)(9)*

Section 1091.5(a)(9) provides:

> "(a) An officer or employee shall not be deemed to be interested in a contract if his or her interest is any of the following: [¶] . . . [¶] (9) *That of a person receiving salary, per diem, or reimbursement for expenses from a government entity, unless the contract directly involves the department of the government entity that employs the officer or employee*, provided that the interest is disclosed to the

> body or board at the time of consideration of the contract, and provided further that the interest is noted in its official record." (Italics added.)

"Hence, under the terms of subdivision (a)(9) of section 1091.5, a government employee who serves on the board of another public agency is deemed not to be financially interested in a contract between the agency and his employer unless the contract directly involves the particular department in which he is employed." (83 Ops.Cal.Atty.Gen., *supra*, at p. 248.)

1. *Salary includes pension benefits*

The trial court found the "salary" exception to prohibited financial interests inapplicable because when the Legislature amended section 1091.5(a)(9) in 1999, it changed the language "from 'compensation' to 'salary, per diem or reimbursement for expenses,' a more narrowly defined class of benefits, the Legislature's omission of 'pension benefits' indicates the intention not to include pension benefits within the scope of the exemption[] presented in . . . [section] 1091.5(a)(9)." This finding was erroneous.

The definition of compensation in Black's Law Dictionary is "[r]emuneration and other benefits received in return for services rendered; esp., *salary* or wages." (Black's Law Dict. (8th ed. 2004) p.301, col. 1, italics added.) Salary is defined as "[a]n agreed compensation for services—esp. professional or semiprofessional services—usu. paid at regular intervals on a yearly basis, as distinguished from an hourly basis." (*Id.* at p. 1364, col. 1.) Thus, salary and compensation are largely synonymous terms. Moreover, a pension is defined as "[a] fixed sum paid regularly to a person (or to the person's beneficiaries), esp. by an employer as a retirement benefit." (*Id.* at p. 1170, col. 1.)

Thus, as salary is a type of compensation, and a pension is merely a deferred payment of such salary, pension benefits can be reasonably interpreted as coming within the definition of salary under section 1091.5(a)(9). This conclusion is bolstered by decisions from the California Attorney General's office, as well as the Political Reform Act of 1974 (PRA), section 81000 et seq.

In 89 Ops.Cal.Atty.Gen. 217 (2006), the Attorney General was asked to answer the following question: "Where a member of the governing board of a community college district receives retirement health benefits from the district as a former faculty member in an amount that is required by contract to be equal to the amount of health benefits the district provides to current faculty members under the terms of a collective bargaining agreement, may the governing board renegotiate the amount of health benefits provided under the current collective bargaining agreement?" The Attorney General concluded that the member of the board receiving the retirement benefits could not participate in the decisionmaking process regarding the health benefits because to do so would be a violation of section 1090. (89 Ops.Cal.Atty.Gen, *supra,* at pp. 217-219.) In reaching this conclusion, the Attorney General interpreted the "salary" exception to prohibited financial interests contained in section 1091.5(a)(9). The Attorney General looked to similar language in the PRA, "which generally prohibit[s] public officials from participating in governmental decisions in which they have a 'financial interest.' [Citation.]" (89 Ops.Cal.Atty.Gen., *supra*, at p. 222.) In this regard, the Attorney General stated: "While a 'financial interest' within the meaning of the [PRA] is defined to include '[a]ny source of income' (§ 87103, subd. (c)), 'income' is defined to exclude

'[s]alary . . . received from a state, local, or federal government agency' (§ 82030, subd. (b)(2); see also Cal. Code Regs., tit. 2, § 18705.5 [financial effect of a decision is not material if it affects only the salary, per diem, or reimbursement for expenses that a public official receives from a federal, state, or local governmental entity]). The Fair Political Practices Commission, which administers the [PRA], has determined that retirement benefits are a form of deferred compensation that fall within the 'salary' exclusion of section 82030, subdivision (b)(2). (*In re Moore* (1977) 3 FPPC Ops. 33.)" (89 Ops.Cal.Atty.Gen., *supra*, at p. 222.) Noting that "[r]etirement benefits 'are not gratuities but represent deferred compensation for past service'" (*id.* at p. 220, fn. 4.), the Attorney General concluded that that the term "'salary' may be construed to include a retired employee's health benefits." (*Id.* at p. 220, fn. omitted.)[8]

Our own review of relevant provisions of the PRA and case law interpreting it support the conclusion that the term "salary" in section 1091.5(a)(9) includes pension benefits.

Section 87100 provides: "No public official at any level of state or local government shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest."

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8 In defining "salary" to include benefits, the Attorney General was interpreting the remote interest exception contained in section 1091, subdivision (b)(13). (89 Ops.Cal.Atty.Gen., *supra*, at p. 220.) However, the relevant language of the statutes is identical.

An exception to the term "financial interest" is contained in section 82030, subdivision (b)(2), for "[s]alary and reimbursement for expenses or per diem, and social security, disability, or other similar benefit payments received from a state, local, or federal government agency . . . ." The term "salary" in this code section has been defined in regulations promulgated to interpret the PRA as including "any and all payments made by a government agency to a public official, or accrued to the benefit of a public official, as consideration for the public official's services to the government agency. Such payments include . . . *pension benefits* . . . ." (Cal. Code Regs., tit. 2, § 18232, italics added.)

In *In re Moore* (1977) 3 FPPC Ops. 33 [1977 WL 45941], the California Fair Political Practices Commission (the Commission) , which enforces the PRA, was asked whether a retired county employee who received a pension from the county and served on the county board of retirement could vote on decisions that could result in enhanced pension benefits. The Commission concluded that he could because pensions benefits are included within the definition of salary under section 82030, subdivision (b)(2): "A pension . . . is essentially a type of deferred salary whereby an employee agrees to receive a smaller payment while working in exchange for the security of receiving the remaining portion of his compensation after he retires. [¶] Since a pension is, in essence, a deferred salary payment, we conclude that it is included in 'salary,' as that term is used in Section 82030[, subdivision] (b)(2). We note, moreover, that the pension in the present case is from a local government agency. The retirement fund is simply the accounting mechanism used by the county to accumulate and disburse the pension benefits.

Accordingly, we conclude that the pension is 'salary . . . from . . . a local government' agency and is, therefore, excluded from the definition of income by Section 82030[, subdivision] (b)(2). [¶] Based on the foregoing analysis, it is clear that the pension received by the retired employee from the county retirement system does not constitute a 'financial interest' within the meaning of Section 87103. Consequently, the retired employee is not prohibited by Section 87100 from participating in board of retirement decisions" concerning matters that might increase pension benefits. (*In re Moore, supra,* 3 FPPC Ops. 33 [1977 WL 45941], fn. omitted.)

It is true, as the trial court found, that when the Legislature amended section 1091.5(a)(9) in 1999, it changed the language from "compensation" to "salary, per diem, or reimbursement for expenses." (Assem. Amend. to Sen. Bill No. 689 (1999-2000 Reg. Sess.) June 30, 1999.) However, this does not mean, as the trial court found, that by changing this language the Legislature intended to exclude pensions from section 1091.5(a)(9). Rather, the only rational explanation is that the Legislature sought to more closely track the language of the PRA, which excludes "[s]alary and reimbursement for expenses or per diem . . . from a . . . local . . . government agency . . . " from the definition of prohibited financial interests. (§ 82030, subd. (b)(2).)

This conclusion is compelled by the fact that the PRA and section 1090 are "in pari materia," which means ""[o]f the same manner; on the same subject."" (*Honig, supra,* 48 Cal.App.4th at p. 327.) "They both deal with a relatively small class of people, public officers and employees, and share the same purpose or objective, the prevention of conflicts of interests, and hence can fairly be said to be in pari materia. [Citation.] [¶]

When statutes are in pari materia, they should be construed together as one statute. [Citation.] So interpreted, ' . . . all parts of a statute should be read together and construed in a manner that gives effect to each, yet does not lead to disharmony with the others.' [Citation.]" (*Ibid.*)

Hence, because the language of section 1091.5(a)(9) and section 82030, subdivision (b)(2) is similar, and they are in pari materia, we must construe them as one, and the definition of salary in both is the same.

From all the foregoing authority, we conclude that pension benefits are salary within the meaning of section 1091.5(a)(9), and thus not a prohibited financial interest under section 1090, as long as the exception created by section 1091.5(a)(9) is otherwise applicable. We conclude that it is not.

2. *The contract directly involved the petitioners' departments*

The noninterest exception of section 1091.5(a)(9) is inapplicable to a contract that "directly involves the department of the government entity that employs the officer or employee." Here, the pension benefits increases in the MOU's directly involved the departments of the petitioners because they granted benefits to the City departments in which they worked. They received the benefit increases only because of their employment with a particular department.

This conclusion is better understood when one looks at 78 Ops.Cal.Atty.Gen. 362 (1995), an Attorney General's opinion interpreting the noninterest exception set forth in section 1091.5(a)(9). In this opinion the Attorney General was asked whether "an individual [may] simultaneously serve as a San Bernardino County Sheriff's Deputy

Chief and Yucaipa City Councilman," and, if so, "may the city council enter into a contract with the sheriff to provide law enforcement services to the city?" (78 Ops.Cal.Atty.Gen., *supra*, at p. 362.) The Attorney General opined that the individual could serve as a sheriff's deputy and a city council member at the same time, and in such a situation the city council could enter into a contract with the sheriff's department to provide law enforcement services, but only if the council member/deputy sheriff did not participate in the decisionmaking process: "[S]ubdivision (a)(9) of section 1091.5 may be construed as allowing a government employee who serves on the board of another public agency to vote on a contract between the agency and his government employer except when the contract involves his particular employing unit. Under this interpretation, the prospective councilman here could not participate in the decision to contract for law enforcement services, since the contract would specifically affect his own employing unit." (78 Ops.Cal.Atty.Gen., *supra*, at pp. 369-370.)

In 85 Ops.Cal.Atty.Gen 115 (2002), another Attorney General opinion discussing the noninterest exception of section 1091.5(a)(9), the Attorney General was asked whether an individual could simultaneously hold the position of city council member and deputy county counsel, and, if so, could the city council enter into a contract with the county to provide law enforcement services. The Attorney General opined that the noninterest exception of section 1091.5(a)(9) applied as to the individual with dual employment as the contract did not directly involve the individual's employing unit:

> "Hence, a government employee who serves on the board of another public agency is deemed not to be financially interested in a contract between the agency and his or her employer unless *the contract*

> *directly* involves *the particular department in which he or she is employed.* [Citation.] [¶] With respect to the deputy county counsel in question, the provisions of subdivision (a)(9) of section 1091.5 would be applicable *since the contract would not directly involve the deputy's employing unit -- the county counsel's office within county government.* Thus, the council member's employment with the county counsel's office may be characterized as a 'noninterest' within the meaning of section 1091.5." (85 Ops.Cal.Atty.Gen., *supra*, at p. 119, italics added, fn. omitted.)

Because there was sufficient evidence presented at the preliminary hearing from which "a reasonable person could harbor a strong suspicion" (*Cooley, supra,* 29 Cal.4th at p. 251) that SDCERS voted to approve the MP2 because it was a prerequisite to the City providing enhanced pension benefits, that agreement directly impacted not only all City employees subject to the increased pension benefits, but also each employing unit of petitioners. As in 78 Ops.Cal.Atty.Gen. 362, the financial benefits here were the same for all members of a particular employing unit, and all City employees that were members of the pension system. Thus, section 1091.5(a)(9) does not require that the contract's impact must be personal or unique to the petitioners in order for it to be "direct." Each petitioner received the increase in pension benefits *only* because of their employment with their particular departments. As for Saathoff, if it can be proven that the enhanced pension benefit he received as union president was made contingent upon the SDCERS board approving MP2, the impact to him was not only direct, but personal and unique.

The purpose of section 1091.5(a)(9)'s exception to prohibited financial interests is to allow government officials to participate in making contracts between two public agencies, so long as there is no ability to self deal with the entity that controls the

official's salary. If, as in 85 Ops.Cal.Atty.Gen. 115, the contract at issue does not directly affect the official's department, there is no danger of self dealing. Here, however, because evidence was presented from which "a reasonable person could harbor a strong suspicion" (*Cooley, supra*, 29 Cal.4th at p. 251) that approval of increased pension benefits was contingent on petitioners' approval of MP2, there was the opportunity to engage in self dealing, as each petitioner knew that their respective employing units, and themselves personally, would financially benefit from the transaction.

Because the enhanced pension benefits directly impacted each of petitioners' departments or employing units, the salary exception to section 1091.5(a)(9) does not apply.

C. *Section 1091.5(a)(3)*

Petitioners assert that the "public services" exception contained in section 1091.5(a)(3) applies and therefore their actions do not fall under section 1090. This contention is unavailing.[9]

Section 1091.5(a)(3) provides:

> "(a) An officer or employee shall not be deemed to be interested in a contract if his or her interest is any of the following: [¶] . . . [¶] (3) That of *a recipient of public services generally provided by the*

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9 Petitioners raised this defense for the first time in their reply papers. The People objected and requested that we strike that portion of their reply brief. However, given the importance of the issue, we permitted the People to file a supplemental brief addressing this issue. Accordingly, as they have now been allowed to fully brief the issue, we deny the People's motion to strike. We grant the real party in interest's motion to take judicial notice of the legislative history regarding the provisions of section 1091.5(a)(3). (Cal. Rules of Court, rule 8.252(a); Evid. Code, § 459.)

public body or board of which he or she is a member, on the same terms and conditions as if he or she were not a member of the body or board." (Italics added.)

The only published decision to discuss this exception to section 1090 is *City of Vernon v. Central Basin Mun. Water Dist.* (1999) 69 Cal.App.4th 508, wherein a member of a municipal water district board, who was also an owner and officer of a private water company, purchased reclaimed water from the district for his company. The Court of Appeal held that the continuing sales of reclaimed water to the company constituted "public services generally provided" within the meaning of section 1091.5, subdivision (a)(3). In doing so, the Court of Appeal stated, "Plaintiff . . . contends that delivery of reclaimed water does not constitute 'public services generally provided,' because the reclaimed water is provided only to 23 wholesale purveyors of reclaimed water, of which [defendant] is one. Plaintiff argues that the phrase 'public services generally provided' must be construed to mean 'services provided to the general public,' or to the 'public at large.' We disagree. Plaintiff is advocating that we rewrite the words of the statute. Public agencies provide many kinds of 'public services' that only a limited portion of the public needs or can use. This does not derogate from their characterization as 'public services' according to the ordinary meaning of those words. The fact that [the water district] distributes reclaimed water through intermediaries does not negate the public service nature of providing reclaimed water. There are 23 purveyors, all of whom are charged the same set rate. This is sufficient to establish that the public services, delivery of reclaimed water, are 'generally provided' 'on the same terms and conditions as if [the board member] were not a member of the board'. . . . [¶] The parties cite no case

construing the 'public services generally provided' language of section 1091.5, subdivision (a)(3). But the trial court's conclusion is supported by an opinion of the Attorney General. (80 Ops.Cal.Atty.Gen. 335 (1997).) There the Attorney General said the 'apparent intent of this provision is to exempt a board member's receipt of public services that are given under "the same terms and conditions" to the other customers of the public agency.' (*Id.* at pp. 337-338.) The Attorney General opined the Legislature contemplated 'the provision of services in accordance with previously adopted rate schedules applicable to all customers.' (*Id.* at p. 338.) This describes the public services which [the water district] provided here, delivery of reclaimed water at a previously adopted rate applicable to all of [the water district's] customers of reclaimed water." (*City of Vernon v. Central Basin Mun. Water Dist., supra,* 64 Cal.App.4th at pp. 514-515, fn. omitted.)

In 81 Ops.Cal.Atty.Gen. 317, 320 (1998), the Attorney General also reviewed the scope of the public services exception of section 1091.5, subdivision (c)(3), stating: "We have examined the legislative history of the 1961 amendment that added the 'public services' exemption to section 1091.5. (Stats. 1961, ch. 381, § 2.) The scope of this exemption is not identified therein. We have previously determined informally, however, that 'public services' would include public utilities such as water, gas, and electricity, and the renting of hangar space in a municipal airport on a first come, first served basis. The furnishing of such public services would not involve the exercise of judgment or discretion by public agency officials. Rather, the rates and charges for the services would

be previously established and administered uniformly to all members of the public. [Citation.]"

The Attorney General concluded in 81 Ops.Cal.Atty.Gen., *supra*, at page 320 that a former city council member who participated in the planning, discussions and city approval necessary to implement a city loan program for developing businesses within the city was precluded from participating in the program, even after he left his position as a city council member. In rejecting the claim that the former city council member's action fell within the no financial interest exception for public services under section 1091.5(a)(3), the Attorney General stated: "Obtaining a government loan involves more complex considerations. The loan applicant must qualify, and the public official approving the loan must exercise some degree of discretion and judgment. Whatever may be of the 'public services' exemption of section 1091.5[(a)(3)], it does not include the extension of a business development loan, where the conditions of the loan would be specific to the particular proposal in question." (81 Ops.Cal.Atty.Gen., *supra*, at p. 320.)

Based upon the foregoing authorities, we conclude that pension benefits are not "public services" that are "generally provided" under section 1091.5(a)(3). "Public services" are services provided by the agency to the public, such as water, gas and electricity. (81 Ops.Cal.Atty.Gen., *supra*, at p. 320.) Here, pension benefits are part of a compensation package that is conferred only on City employees, as opposed to the public, through a contract with the City.

In considering the City's request regarding contribution levels for the pension system, in exchange for increased pension benefits, petitioners were also required to

"exercise some degree of discretion and judgment." (81 Ops.Cal.Atty.Gen., *supra*, at p. 320.) Thus, petitioners' actions fall outside the scope of section 1091.5(a)(3) for this reason as well.

D. *Relevance of City Charter Provisions Mandating Composition of Board*

Petitioners assert that because the City Charter mandated that City employees sit on the SDCERS board, they were required, despite their financial interest, to consider MP2 and the contingent increase in pension benefits. This contention is unavailing.

It is true as petitioners assert, that in 2002, the City Charter, article IX, section 144 provided that that the composition of the SDCERS board consist of 13 members consisting of three specifically designated ex officio positions for the City manager, the City treasurer and the City auditor and comptroller, one position designated to represent fire safety members, one for police safety members, one position to represent retired City employees, and three positions to be elected from the SDCERS active membership. The other four board members were drawn from the community and appointed by the City council.

Petitioners contend that because their presence on the board was mandated by the City Charter, and their status as City employees and members of SDCERS required that they consider contracts in which they had a financial interest and therefore created a conflict under section 1090. They contend that this means either (1) the state in enacting section 1090 voided or preempted article IX, section 144 of the City Charter; or (2) if section 1090 did not void this City Charter article, the legal doctrines of abrogation and preemption preclude prosecution under section 1090.

However, it was not the composition of the board that created an alleged section 1090 conflict, but petitioners' actions taken when faced with that alleged conflict. It was their financial interest in increased pension benefits that were allegedly tied to their approval of MP2. It is true that petitioners were appointed to represent the interests of labor unions or the City when they became board members. However, once they were on the board, their fiduciary duty ran to all members of the pension system. As stated, *ante*, it was not within the purview of the board's responsibilities to make decisions on increases in pension benefits. That was exclusively the City's responsibility. (City Charter, art. IX, § 141.) Their exclusive fiduciary duty was to administer SDCERS in an actuarially sound manner for the benefit of members and beneficiaries. If the People can prove at trial that petitioners knew that an increase in pension benefits was contingent upon their approval of MP2, which the People claim was an action that was not actuarially sound, their actions allegedly *conflicted* with their duties as board members.

For example, in *City of Sacramento v. Public Employees Retirement System* (1991) 229 Cal.App.3d 1470, the City of Sacramento asserted that the California Public Employees' Retirement System (PERS) board's interpretation of a compensation statute resulted in the city being forced to increase its employer contribution, and thus conflicted with the provision in the California Constitution, article XVI, section 17, subdivision (b), providing that "[t]he members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, *minimizing employer contributions thereto*, and defraying reasonable expenses of

administering the system." The Court of Appeal held that the "minimizing employer contributions" language did not conflict with a pension board overriding fiduciary duty to protect its members:

> "The City argues that because PERS's interpretation will increase its costs, it violates [California Constitution, article XVI,] section 17, subdivision (b), because it conflicts with the direction to 'minimize employer contributions.' We disagree. The City's argument is an unfounded expansion of the employer minimization provision which ignores its context in the article as a whole. [¶] To date, there has been no judicial interpretation of the 'employer minimization' provision, which became part of the California Constitution as a result of a 1984 initiative amendment. . . . We agree with PERS that, *even assuming article XVI, section 17 creates a duty to minimize employer contributions, it cannot be construed to require PERS to manage the retirement system in a way which would favor an employer over the beneficiaries to whom it owes a fiduciary duty.*" (*City of Sacramento v. Public Employees Retirement System, supra,* 229 Cal.App.3d at pp. 1493-1494, fns. omitted, italics added.)

Further, it was not necessary for petitioners to consider, negotiate or agree to either the original contribution agreement proposed by the City, or the final version that came to be known as MP2, while passage of that agreement was arguably a contingency to the granting of increased pension benefits. When presented with this proposal from the City, petitioners could investigate and seek legal guidance as to whether a conflict existed.[10] That alone would not implicate section 1090. Obviously, a board (or board member) must have sufficient information before it to enable it to determine if a conflict exists. "To act 'knowingly' the official must be aware 'there is a reasonable likelihood

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10 We note the California Supreme Court has recently held that advice of counsel is no defense to a section 1090 prosecution. (*People v. Chacon, supra,* 40 Cal.4th at p. 570 ["reliance on advice of counsel as to the lawfulness of the conduct is irrelevant"].)

that the contract may result in a personal financial benefit to him.' [Citation.] An official is *not* required to know that his conduct is unlawful." (*People v. Chacon, supra,* 40 Cal.4th at p. 570.) If a conflict exists, board members must (1) refuse to consider the proposed contract until the conflict is removed or (2) abstain from considering or voting on the proposal if the conflict remains; and (3) they may not participate in the process that leads to the making of the contract in which they have a financial interest. It was not the composition of the board that created the alleged conflict, it was petitioners' alleged actions.

E. *Petitioners' Fiduciary Duties*

Petitioners contend that their prosecution under section 1090 criminalizes the exercise of their fiduciary duties. We reject this contention.

In support of their position, petitioners rely on this court's decision in *Bandt v. Board of Retirement* (2006) 136 Cal.App.4th 140 and *Board of Administration v. Wilson* (1997) 52 Cal.App.4th 1109.

In *Bandt v. Board of Retirement,* we recently examined the actions of a county board of retirement in providing benefits for retired county employees. This court concluded that article XVI, section 17, subdivision (b) of the California Constitution did not prevent the county from amortizing the unfunded accrued actuarial liability (UAAL)

in the pension trust fund over a 30-year period, thereby allowing "the [c]ounty to grant an increase in benefits and to pay for the increased cost of the benefits over time as the associated pension obligations become due." (*Bandt v. Board of Retirement, supra,* 136 Cal.App.4th at pp. 158-159.) In reaching this conclusion, we stated: "A decision that increases UAAL is not necessarily bad for members. As the actuary's June 30, 2002 valuation makes clear, the primary cause of the increase in UAAL in the [retirement association's] pension fund in 2002 was an increase in pension benefits valued at approximately $1.1 billion. Obviously, such benefit increases do not harm members. If the [retirement association] were prohibited from increasing UAAL, such benefit increases may not have been granted, since the [c]ounty might have determined that such increases were unaffordable." (*Id.* at p. 157, fn. omitted.)

In *Board of Administration v. Wilson,* the Legislature enacted legislation that allowed the State of California to contribute to the PERS retirement fund 12 months in arrears, as opposed to contributing money in the year that employees' services were rendered. (*Board of Administration v. Wilson, supra,* 52 Cal.App.4th at pp. 1119-1121.) The Court of Appeal held that this violated state employees' right to an "actuarially sound retirement system." (*Id.* at pp. 1118, 1131.) However, the court contrasted the situation

where in exchange for a detrimental contribution change, the pension system receives comparable new advantages: "[The State] argues the trial court erred in ruling that Senate Bill No. 1107 and Senate Bill No. 240 were defective in their failure to provide comparable new advantages in exchange for the adverse effect of in-arrears financing. We disagree. [¶] ""To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, *and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.* [Citations.]"" [Citation.] '*The saving of public employer money is not an illicit purpose if changes in the pension program are accompanied by comparable new advantages to the employee.*'" (*Board of Administration v. Wilson, supra,* at pp. 1144-1145, second italics added.)

From these decisions, petitioners conclude that it is not necessarily a breach of the board's fiduciary duty, and therefore not a violation of section 1090, to grant contribution relief, so long as it is accompanied by a comparable benefit improvement.

However, a violation of section 1090, under its broad terms "is not limited to instances of actual fraud, dishonesty, unfairness or loss to the governmental entity, and criminal responsibility is assessed without regard to whether the contract in question is fair or oppressive. [Citation.] Thus, it has been repeatedly held that such matters are irrelevant under section 1090." (*Honig, supra,* 48 Cal.App.4th at p. 314.)

Accordingly, whether or not petitioners' actions in considering enhanced pension benefits in exchange for decreased contributions constituted a breach of their fiduciary

duty to members of the pension system is irrelevant to the question of whether they may be charged under section 1090.

Further, even petitioners admit that a pension board is not "entitled simply to accept benefit improvements as part of a deliberate decision to undermine the actuarial soundness of a fund." As fiduciary counsel explained to the board prior to its July 11 meeting, "If [this argument] were governing, then each time [an] employer persuaded a Board to reduce contributions, it could avoid challenges by increasing benefits. That would not pass elementary actuarial requirements. Instead, as set out in the Municipal Code, whenever benefits are increased they should be paid for in accordance with standard actuarial practice, so normal cost is paid and past service costs [are] amortized . . . ." As stated, *ante*, pension members are entitled by law to an actuarially sound pension system, and it was petitioners' fiduciary duty to ensure that result.

In this matter, evidence was presented at the preliminary hearing from which "a reasonable person could harbor a strong suspicion of the defendant's guilt" (*Cooley, supra*, 29 Cal.4th at p. 251) under section 1090 based upon their actions in considering, discussing, negotiating and ultimately voting to approve MP2 because the increase in pension benefits was, under the evidence presented, arguably conditioned on that approval.

DISPOSITION

The petition is denied. The parties shall bear their own costs in this proceeding.

CERTIFIED FOR PUBLICATION

NARES, Acting P. J.

WE CONCUR:

McDONALD, J.

IRION, J.

EXHIBIT 46

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO
MICHAEL J. AGUIRRE
CITY ATTORNEY

CIVIL DIVISION
1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
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September 7, 2007

Honorable Jerry Sanders, Mayor
City of San Diego
202 C Street, 10th Floor
San Diego, CA 92101

Dear Mayor Sanders:

I.
BACKGROUND

On 14 November 2006 the U.S. Securities & Exchange Commission (SEC) issued a cease and desist order finding that San Diego City officials violated the anti-fraud provisions of the federal securities laws.[1] The SEC determined that San Diego City officials and employees withheld information concerning hundreds of millions of dollars of pension and retiree health debt from investors in the City's bonds. The SEC made numerous findings regarding the conduct of City officials:

- The SEC found that the City of San Diego faced a "financial crisis," and in failing to disclose critical facts about its pension and retiree health care debt violated "the antifraud provisions of the federal securities laws in connection with the offer and sale of over $260 million in municipal bonds in 2002 and 2003. At the time of these offerings, City officials knew that the City faced severe difficulty funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, or City services were cut."[2] (emphasis added.)

- The SEC found the "City's looming financial crisis resulted from (1) the City's intentional under-funding of its pension plan since fiscal year 1997; (2) the City's

[1] 14 November 2006 SEC Cease and Desist Order p. 2 ("SEC Cease & Desist Order"). (Exhibit 1.)

[2] SEC Cease and Desist Order p. 2, attached as Exhibit 1.

granting of additional retroactive pension benefits since fiscal year 1980; (3) the City's use of the pension fund's assets to pay for the additional pension and retiree health care benefits since fiscal year 1980; and (4) the pension plan's less than anticipated earnings on its investments in fiscal years 2001 through 2003."[3] (emphasis added.)

- The SEC found City officials did not disclose the "gravity of the City's financial problems" including that the "City's unfunded liability to its pension plan was expected to dramatically increase, growing from $284 million at the beginning of fiscal year 2002 and $720 million at the beginning of fiscal year 2003 to an estimated $2 billion at the beginning of fiscal year 2009." Also not disclosed was the fact that the City's "projected annual pension contribution would continue to grow, from $51 million in 2002 to $248 million in 2009." Also not disclosed was the fact that the "estimated present value of the City's liability for retiree health benefits was $1.1 billion."[4]

- The SEC found that the City used the improper practice of applying "surplus earnings—i.e., earnings above the actuarially projected 8% return rate -- to fund an ever-increasing amount of additional benefits for San Diego City Employees' Retirement System members."[5]

- The SEC found that in "fiscal year 1996, the City agreed to increase significantly and retroactively all employees' pension benefits. The City, however, could not afford to fund the cost of the benefit increases. The City, therefore, made the pension benefit increases contingent on CERS's agreement to the City's under-funding of its annual contribution to CERS."[6] (emphasis added.)

- The SEC found that in "March 2000, the City again retroactively increased pension benefits. Specifically, the City and CERS settled a class action lawsuit brought by CERS members, with Corbett as the named class plaintiff. Under the Corbett settlement, the City retroactively gave increased pension benefits to both current and retired City employees, increasing CERS's liabilities."[7]

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[3] SEC Cease and Desist Order p. 2. (Exhibit 1.)

[4] SEC Cease and Desist Order pp. 2-3. (Exhibit 1.)

[5] SEC Cease and Desist Order pp. 6-7. (Exhibit 1.)

[6] SEC Cease and Desist Order p. 7. (Exhibit 1.)

[7] SEC Cease and Desist Order pp. 7-8. (Exhibit 1.)

- The SEC found that in "April 2002, the City received a warning that the City's pension and retiree health care liabilities would continue to grow and that the City was not adequately planning to meet those liabilities." The warning, according to the SEC, came in the form of a report from "the City's Blue Ribbon Committee to the City Council."[8]

- The SEC found that in "fiscal year 2003, the City again increased its pension liability by granting additional retroactive benefits, used additional CERS assets to pay for additional pension and retiree health care benefits and an increased portion of the employees' contribution, and obtained additional time to underfund its annual CERS contribution."[9]

- The SEC found that the City received two reports from CER's actuary that provided "the City with negative information regarding the present and projected status of CER's funded ratio and the City's unfunded liability to CERS." According to the SEC, one report showed that the pension had "suffered an actuarial loss of $364.8 million and that as of the end of fiscal year 2002, CER's funded ratio was 77.3% and the City's unfunded liability to CERS was $720 million."[10] The second report, according to the SEC, showed that the "City's contribution rate was projected to more than quadruple-9.83% of payroll in fiscal year 2002 ($51 million) to 35.27% of payroll in fiscal year 2009 ($248 million)."[11]

- The SEC found the City's financial adviser gave City officials "additional information regarding the projected growth of its future pension liabilities and the possible negative effect those liabilities would have on the City's credit rating and ability to issue municipal securities." According to the SEC, in April 2003, the financial adviser informed City officials that the "City's unfunded liability to CERS would grow to $1.9 billion at the end of fiscal year 2009 and to $2.9 billion at the end of fiscal year 2021, and CERS's funded ratio would fall to 66.5% at the end of fiscal year 2009 and would be 67% at the end of fiscal year 2021."[12]

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[8] SEC Cease and Desist Order p. 9. (Exhibit 1.)

[9] SEC Cease and Desist Order p. 9. (Exhibit 1.)

[10] SEC Cease and Desist Order p. 10. (Exhibit 1.)

[11] SEC Cease and Desist Order p. 10. (Exhibit 1.)

[12] SEC Cease and Desist Order pp. 13-14. (Exhibit 1.)

- The SEC found that the "City, through certain of its officials, knew that its Disclosures were misleading. The Mayor and Council were responsible for approving the issuance of the bonds and notes, including issuance of the preliminary official statements and official statements."[13]

On 5 September 2003, SDCERS Trustee Diann Shipione sent an e-mail to SDCERS' Administrator Lawrence Grissom warning that bond offering documents being used by the City of San Diego to sell sewer bonds were inaccurate.[14] Ms. Shipione called special attention to the statements made in the disclosure document that the SDCERS actuary had determined that the funding method being used by the City in its pension plan was "an excellent method for the City and it will be superior to the PUC method." In fact, the funding method was being used to hide hundreds of millions of dollars of pension benefits that had been illegally created by City officials.

Ms. Shipione's e-mail caused the City's bond offering to be halted. On 27 January 2004 the City was required to disclose to its current bond investors hundreds of millions of dollars of debt not properly disclosed by the City previously. These disclosures prompted the SEC investigation mentioned above beginning in February 2004. Following the disclosures of the pension and retiree health care debt, the City of San Diego essentially lost its credit rating and has been unable to access the public securities markets.

With this record it is imperative that the City of San Diego restore reliable internal controls in order to ensure that investors in City bonds receive information necessary to make informed decisions relevant to San Diego City bonds. As indicated in the SEC cease and desist order the City is required to increase revenues, decrease pension and retiree health care debt, or cut city services. City officials know that revenues have not been materially increased nor have debt or service levels been materially lowered. Moreover, there are several remedial actions necessary, but not yet adopted, to place the city on a sound financial footing that would permit the City to return to the public securities markets.

II.
REMEDIATION

1. Rescind MP-1 and MP-2 Benefits

As discussed in the SEC cease and desist order the City awarded retroactive benefits in exchange for funding the pension fund below the required actuarial level. These benefits were awarded for work already performed and without funding. These benefits constitute gifts of

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[13] SEC Cease and Desist Order p. 17. (Exhibit 1.)

[14] 5 September 2003 e-mail from Diann Shipione, SDCERS Board Trustee, to Lawrence Grissom, administrator with SDCERS. Subject: "Incorrect Pension Materials in Bond Solicitation Circular." (Exhibit 2.)

public funds', prohibited payments for work already performed, and were given in violation of the liability limit laws. Under the State Constitution and City Charter the benefits are illegal and must be rescinded.

2. Actual Value of Purchase Service Credits

City employees were permitted to buy purchase service credits but they were allowed to do so at below the full value. Granting purchase service credits at prices below the value received by the City employees constitutes a gift of public funds and violates the liability limit law both of which are prohibited by the City Charter and State Constitution. The 17,000 years of purchase services credits must be reduced to actual value.

3. Actual Value of DROP

City employees were permitted to enter into a deferred retirement option plan that allowed them to receive a retirement distribution while still working and receiving their salary. DROP was also supposed to be cost neutral but in fact the program has been administered at a cost to the City of several hundred million dollars. Granting DROP on its current terms is a gift of public funds and a violation of the liability limit law. The DROP program must be reduced to a cost neutral level.

4. Purchase Service Credits 10 and 20 year Vesting

The City Charter requires employees work for 10 years to vest in the City's pension plan and 20 years to retiree with additional benefits. The City Council adopted a provision that allows city employees to purchase 5 years of purchase service credits to satisfy the 10 year vesting, after only working for 5 years. A practice has been adopted by the City pension system allowing employees to buy years of purchase service credits to satisfy the 20 year vesting provision that allows for additional benefits. These programs violate the Charter and should be discontinued.

5. City Attorney Counsel for Pension System

The San Diego City Charter and Municipal Code §24.0910 provide that the City Attorney appoints the attorney for the City's pension system. The City Attorney has not been permitted to name the pension system's attorney. The City Attorney under the Charter and Municipal Code should be reinstated as the attorney for the pension system.

6. Reform Management of Pension System

The management of the pension system must be reformed in order to restore the internal controls of the City's financial system. Recently, the City Attorney's office discovered that the Internal Revenue Service in March 2007 determined that the City must immediately pay $100 million into the pension fund liability to replace funds used to pay for health benefits. This information has not been disclosed in the City's financial statements. Moreover, the trustees

who were appointed are not dedicated to establishing reliable internal controls within the pension system. Responsible trustees must be appointed before the City can represent to investors that it has put in place proper internal controls.

7. Remove Surplus Earnings

The pension system uses a discredited and improper method known as "surplus earnings" to distribute pension assets to pay for "contingent" benefits. Despite repeated efforts to repeal the surplus earnings provisions from the Municipal Code a majority of the City Council, under direction from the pension board administration, has failed to act. Again, this provision must be removed from the Municipal Code and the practice stopped.

8. Misrepresentation in IRS 5300 Determination Letter

The pension system has applied for an IRS Determination Letter under the voluntary compliance program that allows pension systems to correct prior misconduct and receive a determination letter from the IRS that the system is operating within IRS rules. The City Attorney has reviewed two letters from the pension system to the IRS dated 14 March and 20 March 2007. These letters fail to disclose pertinent information to the IRS. For example, in regards to the former trustee who received an unfunded increase in his retirement benefit no mention is made of the relationship between his increased benefit and his role in securing approval of the City's continued underfunding of the pension plan. Also no mention is made of the fact that funds were not withheld for a portion of his benefit to cover the costs of his increased benefits. Again, the City, as plan sponsor must review the representations made by the pension system representatives to ensure that there are no material misrepresentations.

9. Confirm DROP Purchase Service Credit Ended 2005

Two legal opinions have been sent to the pension system administrators confirming the fact that DROP and Purchase Service Credit benefits were ended as of July 2005. The system administrator has informed the City that the pension system does not recognize the end date for these benefits as July 2005. The pension system is refusing to follow the clear language of the Municipal Code. This issue must be resolved so that accurate information about the City's pension liabilities can be provided in our financial statements.

10. Reduce and fund pension deficit of $1 billion within 15 year amortization

The City must take all reasonable steps to reduce the $1 billion pension deficit by removing the benefits that were granted unlawfully. Court rulings have shown that the City must act affirmatively to delete retroactive benefits, DROP benefits given at levels above actual costs, and purchase of service credits granted above actual value. Removing these benefits will reduce the pension deficit by hundreds of millions of dollars. As for the remaining debt it must be amortized under our Charter within 15 years as directed by voters in 2004. The Mayor has adopted the position of the pension board while ignoring the written advice letter provided by the

City Attorney's office. These steps must be taken if the City is to avoid a massive tax increase to pay for these illegal benefits.

11. Reduce and Fund Retiree Health Care Deficit

In a series of agreements made without providing same year funding City officials have created a $1.4 billion health care benefit deficit for retirees. This deficit must be reduced by deleting the benefits conferred without proper funding e.g. indexing retiree health benefits to federal actuarial increases. The deficit based upon legitimate health care benefits for retirees must be paid and not simply pushed off to future generations.

12. Retain City Actuary

The City must retain an actuary in order to have an independent source of information to make informed decisions about the pension debt crisis the City faces.

13. Continue Litigation to Remove Illegal Pension Benefits

City officials have a fiduciary duty to remove the illegal pension benefits and to take all necessary and appropriate legal action related to avoiding the illegal portion of the pension debt. Recent emails from City union leaders make it clear that a campaign has been and is underway to pressure the City Attorney from dropping the pension cases aimed at removing illegal pension debt from the City's books. Certain council members have appeared to join in that campaign. The Mayor and City Council must take all steps necessary to remove the illegal debt including pursuing pension related litigation.

14. False or Misleading Statements About City Financial Condition

The Mayor[15] and certain City Council members have made statements that could be interpreted as false and misleading concerning the City's financial condition. These statements suggest that the City has resolved its financial problems. Unfortunately, based, in part, on last

[15] In August the Mayor told San Diego Magazine in a published interview that the City was "in much better shape." The Mayor stated: "We've got payment schedules worked out with this five-year plan and the budget we just adopted for fixing most of the major financial issues." The Mayor also stated that "we're actually paying in more than we're required to." He then went on to say with regard to the retiree health care that "no body even anticipated." (Exhibit 3.) These statements were false and misleading. There are no payment schedules "worked out." The five year plan assumes wage increases at rates below those given. The payments to the pension plan are back-loaded for years after the Mayor's term would expire. The City is required under law to pay within a 15 year amortization schedule the Mayor is using a 20-year amortization which means the City is paying less than required not more as he has represented. Finally, the retiree health care deficit has been known for several years and, like the Mayor's plan, pushed off to future generations.

year's salary increases and also on the failure to take needed corrective action of decreasing pension and retiree health debt the City is still in critical financial condition.

III.
CONCLUSION

City officials destroyed the City's credit rating by increasing pension and retiree health care benefits without proper funding and in violation of local and state laws. The SEC issued a cease and desist order finding these City officials engaged in securities fraud. The SEC identified the massive debt facing the City and noted that the only way to solve the problem created was by decreasing the debt, increasing the revenues, or cutting services.

Rather than do the work needed to get rid of the illegal debt and fund the remaining obligations, the Mayor and certain members of the City Council have opted to continue the past practices of relying on the pension system's phony numbers and pushing the debt off to future generations. The City must reverse course and make the hard choices needed to return the City to financial health before it can re-enter the public financial markets.

All of the points listed above must be dealt with by swift and decisive council action or our great City will find itself even more at peril than it presently is.

Very truly yours,

MICHAEL J. AGUIRRE, City Attorney

MJA:meb

cc: Honorary Councilmembers
Congressman Barney Frank, Chairman, House Financial Services Committee
Linda Chatman Thomsen, Securities and Exchange Commission
Kelly Bowers, Securities and Exchange Commission

Exhibit 1

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8751 / November 14, 2006

SECURITIES EXCHANGE ACT OF 1934
Release No. 54745 / November 14, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12478

In the Matter of City of San Diego, California, Respondent.	ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against the City of San Diego, California (the "City" or "Respondent").

II.

In anticipation of the institution of these proceedings, the City has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, the City consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and the City's Offer, the Commission finds that:[1]

A. SUMMARY

This matter involves the City of San Diego's violations of the antifraud provisions of the federal securities laws in connection with the offer and sale of over $260 million in municipal bonds in 2002 and 2003. At the time of these offerings, City officials knew that the City faced severe difficulty funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, or City services were cut. The City's looming financial crisis resulted from (1) the City's intentional under-funding of its pension plan since fiscal year 1997; (2) the City's granting of additional retroactive pension benefits since fiscal year 1980; (3) the City's use of the pension fund's assets to pay for the additional pension and retiree health care benefits since fiscal year 1980; and (4) the pension plan's less than anticipated earnings on its investments in fiscal years 2001 through 2003.

Despite the magnitude of the problems the City faced in funding its future pension and retiree health care obligations, the City conducted five separate municipal bond offerings, raising more than $260 million, without disclosing these problems to the investing public. In each of these offerings, the City prepared disclosure documents that are used with municipal securities offerings—that is, preliminary official statements and official statements—and made presentations to rating agencies.[2] In addition, in 2003 it prepared and filed information pursuant to continuing disclosure agreements under Exchange Act Rule 15c2-12 with respect to $2.29 billion in outstanding City bonds and notes.[3] Although the City provided some disclosure about its pension and retiree health care obligations, it did not reveal the gravity of the City's financial problems, including that:

- The City's unfunded liability to its pension plan was expected to dramatically increase, growing from $284 million at the beginning of fiscal year 2002 and $720

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[1] The findings herein are made pursuant to the City's offer of settlement and are not binding on any other person or entity in this or any other proceeding.

[2] An official statement is a document prepared by an issuer of municipal bonds that discloses material information regarding the issuer and the particular offering. A preliminary official statement is a preliminary version of the official statement that is used to describe the proposed new issue of municipal securities prior to the determination of the interest rate(s) and offering price(s). The preliminary official statement may be used to gauge interest in an issue and is often relied upon by potential purchasers in making their investment decisions.

[3] Continuing disclosures are disclosures of material information relating to prior years' municipal bond offerings that are periodically provided to the marketplace by the bonds' issuer pursuant to contractual agreements and Exchange Act Rule 15c2-12.

million at the beginning of fiscal year 2003 to an estimated $2 billion at the beginning of fiscal year 2009;

- The City's total under-funding of the pension plan was also expected to increase dramatically, growing tenfold from $39.2 million in fiscal year 2002 to an estimated $320 to $446 million in fiscal year 2009;
- The City's projected annual pension contribution would continue to grow, from $51 million in 2002 to $248 million in 2009; and
- The estimated present value of the City's liability for retiree health benefits was $1.1 billion.

The City's enormous pension and retiree health liabilities and failure to disclose those liabilities placed the City in serious financial straits. When the City eventually disclosed its pension and retiree health care issues in fiscal year 2004, the credit rating agencies lowered the City's credit rating. The City also has not obtained audited financial statements for fiscal years 2003, 2004, and 2005.

Consequently, the City violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit the making of any untrue statement of material fact or omitting to state a material fact in the offer or sale of securities.[4]

B. THE RESPONDENT

City of San Diego, California is a California municipal corporation with all municipal powers, functions, rights, privileges, and immunities authorized by the California Constitution and laws, including the power to issue debt. The City is the seventh most populous city in the country, with approximately 1.3 million residents.

C. RELATED PARTY

San Diego City Employees' Retirement System ("CERS") is a defined benefit plan[5] established by the City to provide retirement, disability, death, and retiree benefits to its members,

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[4] The Commission acknowledges that in the City's offering documents for sewer revenue bonds issued in 1995, 1997, and 1999 and sewer revenue bonds that were offered but not issued in 2003, in its continuing disclosures, and in its communications with rating agencies, the City failed to disclose that the City's wastewater fee rate structure did not comply with certain federal and state clean water laws, that the City was not in compliance with the terms of certain government grants and loans, and that the City could have been required to repay those grants and loans due to such non-compliance. The offerings in the 1990s, however, predate the offerings that are the subject of this Order, and the City did not consummate the 2003 offering because issues arose regarding the adequacy of its pension disclosure. In addition, in 2004, the City came into compliance with the federal and state clean water laws and the grant and loan covenants by adopting a new fee rate structure. The City thereby avoided having immediately to repay the government grants and loans.

[5] A defined benefit plan is a traditional pension plan under which pre-determined retirement benefits are based on a formula established by factors such as age, years of service, and

i.e., City employees and their beneficiaries. CERS is administered by the CERS Board, which during the relevant period included eight City employees, including the City Treasurer and the Assistant City Auditor and Comptroller, one retiree, and three non-employee City citizens appointed by the City Council as CERS Board members.

D. FACTS

1. Background

a. Structure of the City's Government

Until January 2006, the City's form of government was a city manager system.[6] Legislative powers of the City were vested in the City Council ("Council"), which made policies and appointed a professional city manager to carry out those policies. The Council was composed of nine full-time Council members who served for staggered four-year terms. Eight of the Council members represented the City's eight districts. The Mayor, who was elected at large, presided at the meetings of the Council and served as the official head of the City for ceremonial purposes. The Mayor and each Council member had one vote; the Mayor had no veto power.

Prior to 2006, the City Manager ("Manager") was the City's chief administrative officer and had substantial control over local government decisions. The Manager, appointed by the Mayor and Council, advised the Council of the City's present and projected financial condition, appointed and removed all city department heads (except the City Auditor and Comptroller ("City Auditor"), City Attorney, and City Clerk), prepared the City's budget, and carried out the Council's budget plan. During the relevant time period, the City's general fund budget was less than $900 million. The City Manager had several Deputy City Managers, one of whom was in charge of the Financing Services Department, which had responsibility for overseeing the City's issuance of municipal securities.

Prior to 2006, the City Auditor was also appointed by the Council, and was required to file at least monthly with the City Manager and Council a summary statement of revenues and expenses for the preceding accounting period.[7] The Auditor was the City's chief financial officer and was responsible for the preparation and issuance of the City's Comprehensive Annual Financial Reports, also referred to as CAFRs. The City's Comprehensive Annual Financial Reports included audited financial statements prepared pursuant to standards established by the

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compensation, and in which the employer bears risk if the employer and employee contributions and the investment return on those contributions are not sufficient to fund the pension benefits.

[6] In January 2006, the City transitioned from a City Manager / Council form of government to a strong Mayor form of government. Under the new system, the Mayor became the City's chief executive officer and the City Manager's position was eliminated. The Council continues to act as the legislative body. City of San Diego City Charter, Article XV.

[7] City of San Diego City Charter, Article V, Section 39.

Government Accounting Standards Board ("GASB")[8] and various statistical, financial, and other information about the City. Portions of the Comprehensive Annual Financial Reports for the years ended June 30, 2001, and June 30, 2002 were attached as appendix B to the preliminary official statements and the official statements. The Comprehensive Annual Financial Reports for 2001 and 2002 were also filed as continuing disclosures.

The elected City Attorney served as the chief legal officer for the City. The City Attorney's office advised the Council, City Manager, and all City departments on legal matters, including disclosure in the City's securities offerings. The City Attorney was responsible for preparing all ordinances, resolutions, contracts, and other legal documents.

b. The City's Pension Plan

The City provided a defined benefit pension plan and retiree health care benefits to its employees through CERS. CERS functioned as a trust for the benefit of its members (i.e., approximately 18,500 current and former City employees and officials). The City was the creator of the trust and determined its terms, including the members' required contributions and the levels of benefits. CERS was administered by a Board of Administration, which controlled the investment of CERS's funds and which owed fiduciary duties to CERS members. CERS's assets consisted of past contributions by the City and CERS members and investment earnings on those funds. CERS's liabilities consisted of operating expenses and the future pension benefits that were owed to members.

Each year, CERS hired an actuary to determine the value of the plan's assets and liabilities based on certain actuarial assumptions and the amount that needed to be contributed to the plan so that the plan accumulated sufficient assets to pay pension (but not health care) benefits when due.[9] Pursuant to the City Charter, the City was to contribute half of that amount, which was expressed in terms of a percentage of payroll expenses, with the other half to be contributed by the employees, which amount was determined as a percentage of compensation based on the employee's age upon entry into CERS.

At least three concepts were particularly important in the disclosure to the public of the City's pension obligations and funding of those obligations: (1) CERS's funded ratio; (2) the

[8] GASB is the organization that establishes standards of state and local governmental accounting and financial reporting.

[9] An actuarial valuation is a determination by an actuary, as of a specified date, of the normal cost, actuarial accrued liability, actuarial value of the assets, and other relevant values for a pension plan based on certain actuarial assumptions. The actuarial value of assets refers to the value of cash, investments, and other property belonging to a pension plan as used by the actuary for the purpose of preparing the actuarial valuation for the pension plan. The actuarial accrued liabilities are what is owed in connection with past services, as determined by one of the actuarial cost methods. Actuarial assumptions are estimates of future events with respect to certain factors affecting pension costs, including rates of mortality, disability, employee turnover, retirement, rates of investment income, and salary increases. Actuarial assumptions are generally based on past experience, often modified for projected changes in conditions.

City's unfunded liability to CERS; and (3) the City's net pension obligation, also called the NPO. CERS's funded ratio was the ratio of its assets to liabilities. The City's unfunded liability to CERS was the dollar shortfall between CERS's assets and liabilities. The City's net pension obligation was the cumulative difference between what the City actually contributed to CERS and the amount that the City would have contributed had it conformed to a funding method recognized by GASB.

2. The City's Pension and Retiree Health Care Benefits and Funding of CERS

The City failed to disclose material information regarding substantial and growing liabilities for its pension plan and retiree health care and its ability to pay those obligations in the future in the disclosure documents for its 2002 and 2003 offerings, in its continuing disclosures filed in 2003, and in its presentations to the rating agencies. As more fully described below, the City's substantial and growing pension and retiree health care liabilities resulted from several factors, including: (1) the City's intentional under-funding of its annual pension contribution; (2) the City's granting of new retroactive pension benefits; (3) the City's use of certain CERS earnings to pay for various additional pension and retiree health care benefits and to pay a portion of employees' pension contributions; and (4) CERS's earning less than anticipated returns on its investments.

a. The City's Historical Practice of Using "Surplus Earnings" to Fund Pension and Retiree Health Care Benefits

In fiscal year 1980, the City began instructing CERS to use "surplus earnings"—i.e., earnings above the actuarially projected 8% return rate[10]—to fund an ever-increasing amount of additional benefits for CERS members. Pension plans typically retain surplus earnings to support the plan's financial soundness and to make up for years in which earnings fall short of the assumed return rate. Rather than retaining its surplus earnings, the City began using surplus earnings in fiscal year 1980 to fund an annual extra or "13th check" to retirees. The City continued using surplus earnings to pay for retiree health care benefits in fiscal year 1982 and to pay an ever-increasing amount of the employees' CERS contributions in fiscal year 1998.[11]

In total, the City used surplus earnings to pay pension benefits and employees' contributions totaling $150 million as of the end of fiscal year 2001 and an additional $25 million as of the end of fiscal year 2002. According to a 2005 CERS audit, the City's use of surplus

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[10] Without regard to its actual historical rate of return on investments, the CERS Board assumed an annual rate of investment return of 8%, which the actuary incorporated into his calculations. CERS defined surplus earnings as the amount of realized investment earnings in excess of the actuarially projected 8% return rate.

[11] In fiscal years 2003 and 2004, the City used CERS's surplus earnings from prior years to pay up to 27% of the employees' contributions.

earnings accounted for 17% of the increase in the City's unfunded liability to CERS from fiscal year 1997 through fiscal year 2003.

b. Manager's Proposal 1: The City Proposes Additional Benefits in Exchange for Contribution Relief

In fiscal year 1996, the City agreed to increase significantly and retroactively all employees' pension benefits. The City, however, could not afford to fund the cost of the benefit increases. The City therefore made the pension benefit increases contingent on CERS's agreement to the City's under-funding of its annual contribution to CERS.

In fiscal year 1997, the City and CERS entered into an agreement, which was referred to as Manager's Proposal 1, that set the City's annual contribution at gradually increasing rates through fiscal year 2008. This funding method, which the City termed "Corridor" funding, was not recognized by GASB and set annual funding rates that were not actuarially determined and were projected to be below GASB-recognized funding rates through fiscal year 2006. In other words, under Corridor funding, the City would be intentionally under-funding its annual liability to CERS in fiscal years 1997 through 2006.[12] After fiscal year 2006, it was estimated that the funding rate of Manager's Proposal 1 would equal a GASB-accepted rate. Manager's Proposal 1 also contained a provision intended to protect CERS's financial soundness. Specifically, if CERS's funded ratio fell below 82.3%, the City would have to increase its CERS contribution rate.

In fiscal years 1996 and 1997, the City estimated that under Manager's Proposal 1, by the end of fiscal year 2008, the City's net pension obligation would be $110.35 million. Because the City's Corridor funding method was not GASB-recognized, GASB required that the City disclose its net pension obligation in its annual financial statements.

c. The *Corbett* Litigation Requires the City to Fund Additional Retroactive Benefits

In March 2000, the City again retroactively increased pension benefits. Specifically, the City and CERS settled a class action lawsuit brought by CERS members, with *Corbett* as the named class plaintiff.[13] Under the *Corbett* settlement, the City retroactively gave increased pension benefits to both current and retired City employees, increasing CERS's liabilities. Under

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[12] Manager's Proposal 1 was viewed skeptically by some members of the CERS Board who were not City employees. The majority of the CERS Board, however, consisted of City officials who received benefit increases that were contingent on the Board's approval of Manager's Proposal 1. Moreover, CERS's actuary informed the CERS Board that Manager's Proposal 1 was a sound proposal and CERS's fiduciary counsel opined that the Board would be acting within the ambit of its fiduciary discretion in approving Manager's Proposal 1.

[13] The *Corbett* plaintiffs raised various claims based on a 1997 California Supreme Court decision which held that an employee's salary for purposes of calculating basic pension benefits included the value of overtime and accrued leave.

Manager's Proposal 1, however, the City's contributions to CERS did not increase. As a result, the City's unfunded liability to CERS increased by $185 million.

In negotiating the *Corbett* settlement, however, the City purposefully structured certain of the increased *Corbett* benefits to avoid having those benefits adversely affect CERS's reported funded ratio and the City's reported unfunded liability to CERS. Specifically, the City structured the *Corbett* settlement so that the increased benefits for retired CERS members were to be paid in a given year only if there were sufficient surplus earnings from that year to pay the benefit. If there were insufficient surplus earnings in a given year to pay the increased benefit, then the cost of the increased benefit would become CERS's liability and would eventually be paid from future years' surplus earnings. The City and CERS treated the increased benefits to retired CERS members as contingent liabilities that were not taken into account in determining CERS's funded ratio or the City's unfunded liability to CERS. As of June 30, 2001, according to CERS's actuary, if the contingent portion of the *Corbett* settlement had been included in CERS's valuation, the City's unfunded liability to CERS would have increased by $70 to $76 million and CERS's funded ratio would have decreased by 2% to 2 ½ % from what was actually reported by the City. Thus, the City's pension situation was even more dire than the numbers, as they were reported by the City, indicated.

d. CERS's Actuary Report for Fiscal Year 2001 Shows a Dramatic Increase in the City's Pension Liabilities

In fiscal year 2001, CERS's investment return began to fall short of its anticipated 8% annual return. The City was informed of CERS's declining performance in February 2002, when it received CERS's annual actuarial valuation for fiscal year 2001. This report stated that as of the end of fiscal year 2001, CERS's funded ratio was 89.9% and the City's unfunded liability to CERS was $284 million, as compared to a funded ratio of 97.3% and an unfunded liability of $69 million only one year earlier. Moreover, the report noted that if the *Corbett* contingent benefit to CERS retired members were included, the City's unfunded liability to CERS would have increased to at least $354 million and CERS's funded ratio would have fallen to at least 87.9%.

CERS's actuary attributed these changes to a number of factors, including CERS's actuarial investment losses[14] of $95.6 million (and warned that there would be further actuarial investment losses in fiscal year 2002 unless the markets improved during the remaining five months of the fiscal year). In his report, CERS's actuary also warned that "all parties" should be "acutely aware that the current practice of paying less than the [actuarial] computed rate of contribution ... will help foster an environment of additional declines in the funded ratio in absence of healthy investment returns."

In May 2002, the City learned that CERS would likely not have any surplus earnings from fiscal year 2002 to pay for the contingent benefits—specifically, retiree health care benefits, the 13th check, and the *Corbett* increase to retirees.

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[14] Actuarial investment losses are the difference between the assumed investment rate, which in the City's case was 8% annually, and the actual investment results.

e. The Blue Ribbon Committee Report Puts the City on Notice about its Growing Pension and Retiree Health Care Liabilities

In April 2002, the City received a warning that the City's pension and retiree health care liabilities would continue to grow and that the City was not adequately planning to meet those liabilities. This came in the form of a report from the City's Blue Ribbon Committee to the City Council.[15] The report stated that the Blue Ribbon Committee had three principal concerns regarding CERS. First, the City was granting retroactive retirement benefit increases but pushing the cost of those benefit increases into the future, long after the individuals involved in the decisions were gone. Second, the City's budgetary process did not adequately comprehend the steadily growing annual expense of the pension contribution, "particularly given the uncontrollable and non-discretionary nature of this liability." The Committee stated that the City's pension contribution would substantially increase and warned that any future benefit increases, particularly retroactive increases, would "significantly exacerbate this problem." Third, the City's budgetary process did not recognize that retiree health care costs were a non-discretionary expense that would grow at an increasing rate and that the City was not paying out of its current year's budget the full cost for their future retiree health benefits. This report thus squarely put the City on notice that it had substantial future pension and healthcare liabilities it would probably be unable to pay under the current system.

f. Manager's Proposal 2: The City Again Proposes Additional Pension Benefits in Exchange for Relief from an Impending Lump Sum Payment

In fiscal year 2003, the City again increased its pension liability by granting additional retroactive benefits, used additional CERS assets to pay for additional pension and retiree health care benefits and an increased portion of the employees' contribution, and obtained additional time to under-fund its annual CERS contribution.

In the second half of fiscal year 2002, the City agreed to increase pension benefits for fiscal year 2003. From as early as October 2001, however, the City was concerned that CERS's funded ratio would fall below the 82.3% floor established by Manager's Proposal 1, which would require the City, at the very least, to increase its contributions to CERS by at least $25 million to be at a higher GASB-accepted rate.

Concerned about having to pay the additional $25 million, the City sought to condition the pension benefit increases on the City's obtaining from CERS relief from the floor of Manager's Proposal 1. In November 2002, the City and CERS agreed to Manager's Proposal 2 and the City

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[15] In April 2001, the Mayor had appointed a nine-member committee of San Diego citizens, known as the Mayor's Blue Ribbon Committee on City Finances, to independently evaluate the City's fiscal health and make any appropriate recommendations. In February 2002, the Blue Ribbon Committee presented its report to the Council's Rules Committee, identifying nine areas of concern, two of which related to the City's pension fund. The same report was made to the full Council in April 2002.

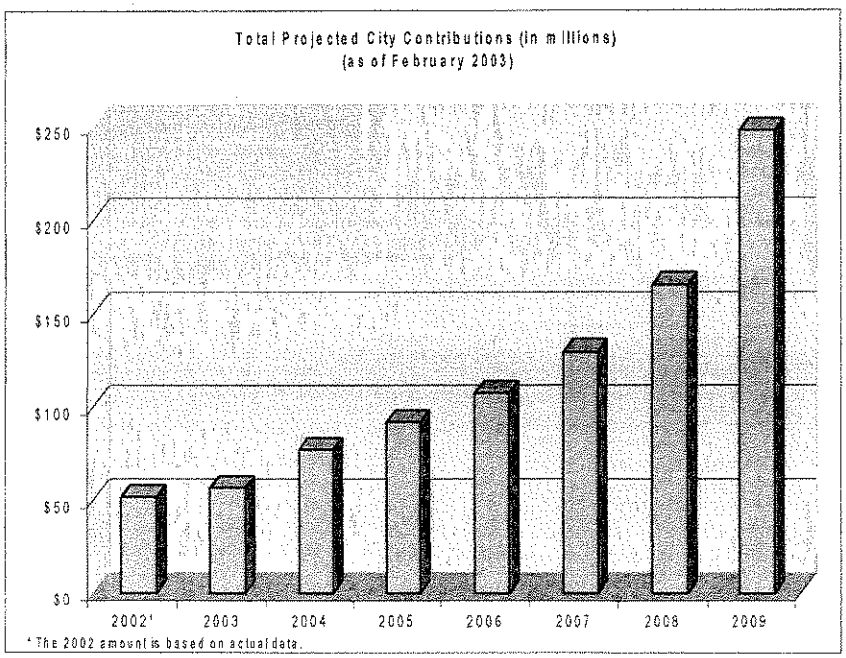
adopted the increased pension benefits as of July 2002. Under Manager's Proposal 2, once CERS's funded ratio fell below 82.3%, the City would have five years to increase its contributions to CERS to reach a GASB-recognized funding rate.

As a result of CERS's actuarial losses in fiscal year 2002, CERS did not have surplus earnings to pay the 13th check, the cost of retiree health care, and the *Corbett* benefit increase to retired CERS members. In conjunction with Manager's Proposal 2, however, the City directed CERS to use certain of its reserve accounts to pay the 13th check and the retiree health care benefits, and to pay an increased portion of certain City employees' CERS contributions. The reserve funds could have been used to increase CERS's funded ratio and decrease the City's unfunded liability to CERS; instead, the City directed that CERS use the reserve funds to pay additional benefits.

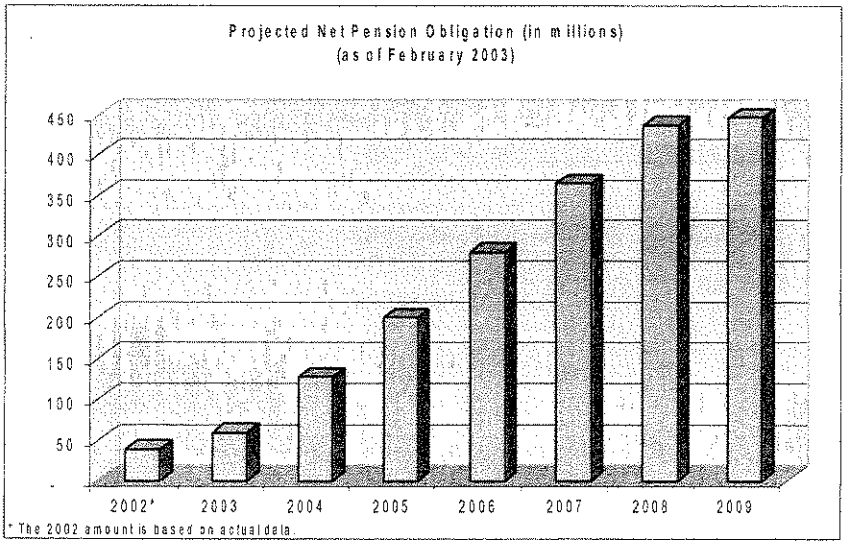
g. CERS's Actuary Report for Fiscal Year 2002 and Projections for the Future Show that the City Faces Substantial Problems Funding its Pension and Retiree Health Care Liabilities

In early 2003, the City received two reports from CERS's actuary. These reports provided the City with negative information regarding the present and projected status of CERS's funded ratio and the City's unfunded liability to CERS. First, in January 2003, the City received CERS's actuary report for fiscal year 2002. This report stated that during fiscal year 2002, CERS suffered an actuarial loss of $364.8 million and that as of the end of fiscal year 2002, CERS's funded ratio was 77.3% and the City's unfunded liability to CERS was $720 million, as compared to a funded ratio of 89.9% and unfunded liability of $284 million only one year earlier. The actuary's report further stated that if the *Corbett* contingent benefit to CERS retired members had been included, the City's unfunded liability to CERS would have been at least $790 million, and CERS's funded ratio would have been approximately 75.3%. In the concluding comment, the actuary stated that CERS was "in adequate condition," which was the first time that the actuary had not described CERS as "actuarially sound."

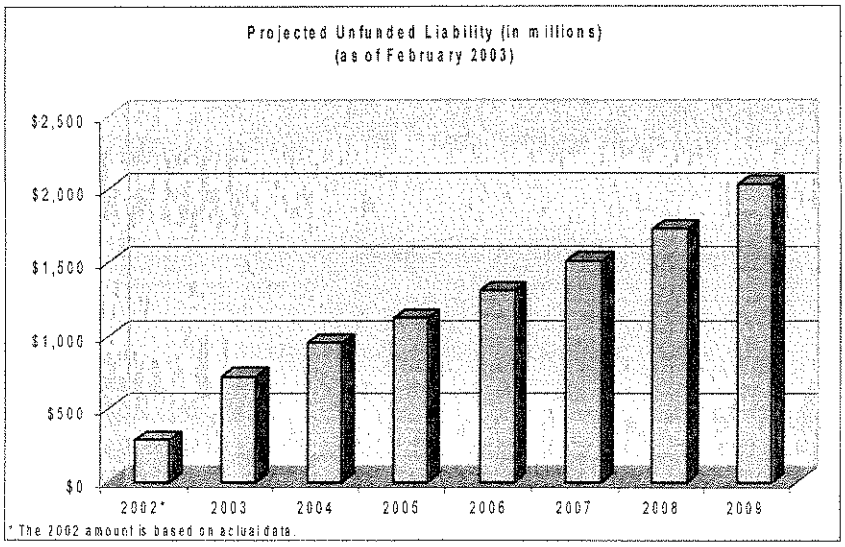
Second, in February 2003, CERS's actuary provided to the City projections of the City's contributions under Manager's Proposal 2, the City's net pension obligation, the City's unfunded liability to CERS, and CERS's unfunded ratio. Specifically, the City's contribution rate was projected to more than quadruple—from 9.83% of payroll in fiscal year 2002 ($51 million) to 35.27% of payroll in fiscal year 2009 ($248 million). The following chart illustrates the growth in the City's projected annual contribution to CERS:



The City's net pension obligation was projected to grow by tenfold—from $39.23 million in fiscal year 2002 to as much as $446 million in fiscal year 2009. The following chart illustrates the growth in the City's projected net pension obligation:



The City's unfunded liability was projected to increase more than seven fold—from $284 million at the beginning of fiscal year 2002 to $2 billion at the beginning of fiscal year 2009. CERS's funded ratio was projected to continue to fall—from 77.3% at the beginning of fiscal year 2003 to 65.6% at the beginning of fiscal year 2009. The following chart illustrates this dramatic increase in the City's projected unfunded liability to CERS:



The City had knowledge of these projections prior to all of its 2003 municipal securities offerings.

h. The *Gleason* Litigation: CERS Members Challenge Manager's Proposal 1 and Manager's Proposal 2

Further evidence that the City's under-funding of CERS was potentially threatening the City's future fiscal health came in January 2003, when CERS members filed a class action, with *Gleason* as the named class plaintiff, against the City and CERS alleging breaches in connection with the City's under-funding of CERS under Manager's Proposal 1 and Manager's Proposal 2. Among other things, the *Gleason* complaint alleged that by 2009, the City would owe approximately $2.8 billion to CERS, with an annual City budget expense of more than $250 million. In March 2003, the CERS attorney in the *Gleason* litigation advised CERS that (1) certain CERS Board members had breached their fiduciary duty by adopting Manager's Proposal 2; and (2) CERS should exercise its right to nullify Manager's Proposal 2. The CERS Board, which included the City Treasurer and the Assistant City Auditor and Comptroller, rejected this advice. If Manager's Proposal 2 had been nullified, the City would have been required to make an immediate potential payment to CERS of up to $159 million.

i. CERS's Response to the Blue Ribbon Committee Report Advises the City's Officials of the Growing Pension and Retiree Health Care Crisis.

In February 2003, additional detailed information about the City's pension funding crisis was presented to City officials when CERS responded to the Blue Ribbon Committee's report.[16] In its response, CERS advised the City that as of June 30, 2002, CERS's funded ratio had fallen to 77.3% and the City's unfunded liability to CERS had increased to $720 million. The response also stated that the falling funded ratio and the increasing unfunded liability resulted from three factors: a dramatic decline in CERS's investment performance in fiscal years 2001 and 2002; the City's granting of increased benefits; and the City's contributions to CERS at less than a GASB-recognized rate.

With respect to the City's under-funding, the response stated that the annual amount of the City's under-funding of CERS continued to increase in fiscal years 2002 and 2003, which was contrary to the initial projections from Manager's Proposal 1 that the annual amount of under-funding would decline beginning in fiscal year 2001. The response further stated that the City's net pension obligation would reach $102 million by the end of fiscal year 2003 and $423 million by the end of fiscal year 2009.

The response also discussed the City's future liability for retiree health care. CERS's actuary had estimated that the present value of the City's liability for future retiree health care was in excess of $1.1 billion. The response further stated that the City was not making any contributions to CERS to pay for this liability, that CERS had been paying for this liability with money in a reserve funded with CERS's surplus earnings from prior years, that the reserve would be depleted in fiscal year 2006, and that in fiscal year 2006, the City would have to pay an estimated $15 million for retiree health care. The response warned that absent a change in the benefit and a dramatic decrease in future health care costs, the City could be facing significant future funding obligations. The response recommended that the City consider funding this future health care liability as part of its annual contribution to CERS.

j. The City's Study of Its Pension Obligations Concludes that the City's Pension Liabilities Could Negatively Impact the City's Credit Rating

In April 2003, the City received additional information regarding the projected growth of its future pension liabilities and the possible negative effect those liabilities would have on the City's credit rating and ability to issue municipal securities. In February 2003, the City hired a financial adviser to analyze CERS's funding and to develop potential solutions. On April 16,

[16] From February 9 through 13, 2003, the local newspaper wrote three front page, above-the-fold articles about the City's under-funded pension system and the CERS response. The newspaper articles explained that (1) by the end of FY 2009 the City's unfunded liability to CERS was projected to increase to almost $2 billion; and (2) the City's unfunded liability for retiree health care was estimated to be $1.1 billion.

2003, the financial adviser provided to the City a preliminary pension analysis. In its analysis, the financial adviser stated that because of the City's under-funding, the City's unfunded liability would continue to grow and CERS's funded ratio would continue to fall through fiscal year 2021 regardless of actuarial gains or losses. The financial adviser estimated that under Manager's Proposal 2, the City's unfunded liability to CERS would grow to $1.9 billion at the end of fiscal year 2009 and to $2.9 billion at the end of fiscal year 2021, and CERS's funded ratio would fall to 66.5% at the end of fiscal year 2009 and would be 67% at the end of fiscal year 2021.

The preliminary pension analysis also stated that the City's large unfunded liability to CERS would cause the City's contribution to CERS to increase dramatically. The analysis estimated that the City's contribution rate to CERS would more than double—from 18.87% of payroll (or $107.5 million) in fiscal year 2004 to 40.9% of payroll ($286.9 million) in fiscal year 2009.

The preliminary pension analysis also discussed the effect that the City's unfunded liability would have on the City's credit rating. The financial adviser stated that the City's current unfunded liability would not only trigger an adverse credit event but that the rating agencies would expect the City to develop a plan to reduce its unfunded liability by increasing its annual contributions and/or funding the unfunded liability by issuing bonds. The financial adviser further stated that if the City did not develop and implement such a plan, the City's unfunded liability could cause the City "significant credit and legal challenges." The City's disclosures in 2003 failed to inform investors of the financial adviser's analysis.

3. The Offerings, Continuing Disclosures, and Rating Agency Presentations

a. The Bond Offerings and the City's Preparation of the Offerings' Disclosure Documents

During 2002 and 2003, the City conducted the following five municipal securities offerings totaling $261,850,000 in par value:

- $25,070,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds, Series 2002B (Fire and Safety Project) (June 2002)
- $93,200,000 City of San Diego, 2002-03 Tax Anticipation Notes Series A (July 2002)
- $15,255,000 City of San Diego/Metropolitan Transit Development Board Authority 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding (April 2003)
- $17,425,000 City of San Diego 2003 Certificates of Participation (1993 Balboa Park/Mission Bay Park Refunding) (May 2003)
- $110,900,000 City of San Diego 2003-04 Tax Anticipation Notes Series A (July 2003)

A transactional financing team prepared the offering documents, that is, the preliminary official statement and the official statement, for each of the five municipal bond offerings. The

financing team consisted of outside consultants and officials from the City Manager's office (financing services division), Auditor and Comptroller's office, and the City Attorney's office. The outside consultants included, among others, bond counsel, disclosure counsel, and underwriters. The preliminary official statement and the official statement for each of the five offerings consisted of a description of the offering, a general description of the City, including financial, economic, statistical, and other information in appendix A, and audited annual financial statements from the City's Comprehensive Annual Financial Reports in appendix B. Information regarding its pension and retiree health care obligations was provided in both appendices A and B.

The outside consultants took the lead in drafting the description of the bond offerings. City officials in the financing services division were responsible for drafting appendix A. The financing services division updated Appendix A on an ongoing basis and at the time of a bond offering, forwarded the latest version of Appendix A to the entire financing team. The team met several times to review, comment on, and ultimately finalize the preliminary official statements and official statements at "page-turner meetings." Appendix B was prepared by the Auditor's office and the City's outside auditor. The Council approved all of the 2002 and 2003 offerings at open session meetings.

b. The Continuing Disclosures

During the relevant period, the City also filed annual continuing disclosures relating to its $2.29 billion in outstanding bonds for the purpose of updating investors on the state of the City's finances.[17] City officials in the financing services division coordinated, reviewed, and filed the 2002 and 2003 continuing disclosures. Almost all of these continuing disclosures included appendix A and portions of the City's Comprehensive Annual Financial Reports. The financing services division was responsible for ensuring that the most updated and accurate version of appendix A was attached to the continuing disclosures before they were filed.

c. The 2003 Rating Agency Presentations

The City made presentations to the rating agencies on a yearly basis, both in connection with specific bond offerings and to update the rating agencies on the City's general credit. The presentations were made orally with PowerPoints in meetings with representatives from Fitch Ratings, Moody's Investors Service, and Standard and Poor's. In 2003, the rating agencies specifically asked the City to address the pension plan as part of its annual presentations. These presentations were important because they directly affected the City's bond ratings. The 2003

[17] An underwriter of municipal securities covered by Exchange Act Rule 15c2-12 may not purchase or sell municipal securities in connection with an offering unless the issuer has undertaken in a written agreement or contract for the benefit of the bondholders to provide its audited annual financial statements and certain other annual financial and operating information, to nationally recognized municipal securities information repositories and state information depositories designated by the Commission and to provide notices of certain material events and notices of any failures to file on the nationally recognized municipal securities information repositories or the Municipal Securities Rulemaking Board and state information depositories.

PowerPoint presentations were prepared and presented by officials from the City Manager's office, including the financing services division, and the City Auditor and Comptroller's office. The financing services division drafted the pension portion of the 2003 PowerPoint presentation. Officials from the City Auditor's office made the oral presentation on the pension plan and fielded numerous questions on that topic from the rating agencies.

4. The False and Misleading Disclosures

In the preliminary official statement and the official statements for the 2002 and 2003 offerings, the 2003 presentations to the rating agencies, and the 2003 continuing disclosures, the City made substantial disclosures regarding (1) the City's policies for funding CERS; and (2) the status of CERS's funding and the City's liability to CERS. Additionally, in the preliminary official statements, the official statements, and continuing disclosures, the City made certain representations regarding its retiree health care obligations. The disclosures (collectively "Disclosures"), however, were misleading because the City failed to include material information regarding the City's current funding of its pension and retiree health care obligations, the City's future pension and retiree health care obligations, and the City's ability to pay those future obligations.

First, with respect to the pension issues, the City failed in the Disclosures to reveal several material facts, including that (1) the City was intentionally under-funding its pension obligations so that it could increase pension benefits but push off the costs associated with those increases into the future; (2) because of the City's under-funding of its pension plan, its net pension obligation was expected to continue to grow at an increasing rate, reaching from $320 million to $446 million by the end of fiscal year 2009; (3) the City's unfunded liability was expected to continue to grow at a substantial rate, reaching approximately $2 billion by fiscal year 2009; (4) this growth in the City's unfunded liability resulted from the City's intentional under-funding of its pension plan, the City's granting of new retroactive pension benefits, the City's use of pension plan earnings to pay additional benefits, and the pension plan's less than anticipated investment return; (5) the City's annual pension contribution was expected to more than quadruple by fiscal year 2009; and (6) the City would have difficulty funding its future annual pension contributions unless it obtained new revenues, reduced pension benefits, or reduced City services. Moreover, the City falsely disclosed in Appendix B to its preliminary official statements and its official statements that its net pension obligation was funded in a reserve.

Additionally, with respect to retiree health care benefits, the City failed to disclose in its preliminary official statements, official statements, and continuing disclosures that[18] (1) the estimated present value of its liability for retiree health care was $1.1 billion; (2) the City had been covering the annual cost for retiree health care with pension plan earnings from prior years that were expected to be depleted in fiscal year 2006; (3) after fiscal year 2006, the City would have to pay for the retiree health care benefits from its own budget at an estimated annual cost of $15 million; and (4) the City had not planned for paying such additional costs.

[18] The issue of retiree health care was not addressed in the rating agency presentations.

5. The City's Knowledge of the Misleading Disclosures

The City, through certain of its officials, knew that its Disclosures were misleading. The Mayor and Council were responsible for approving the issuance of the bonds and notes, including issuance of the preliminary official statements and official statements. The Mayor and Council delegated final approval of the official statements to the City Manager. The City Manager's office was responsible for the preparation of the preliminary official statements and the official statements, including appendix A. The City Auditor's office was responsible for the preparation of appendix B to the preliminary official statements and official statements. Through their designees on the CERS Board, among other things, both the City Manager's and the City Auditor's offices had knowledge about the City's use of CERS's surplus earnings, Manager's Proposals 1 and 2, CERS's actuary reports for fiscal years 2001 and 2002, and CERS's response to the Blue Ribbon Committee Report. Also, several representatives of the City Manager's office, City Attorney's office, and Auditor and Comptroller's office attended relevant closed session meetings of the Council where Manager's Proposals 1 and 2 and the *Corbett* and *Gleason* litigations were discussed. Moreover, the Blue Ribbon Committee Report and CERS's response to the Blue Ribbon Committee Report were both presented to a committee of the Council at which officials from the City Manager's and Auditor and Comptroller's office were present. Finally, the offices of the City Manager and the City Auditor were responsible for the City's study of its pension obligations that occurred in early 2003. Through their participation and involvement in the above-referenced matters, certain city officials knew or were reckless in not knowing that the Disclosures were false and misleading.

Specifically, by early 2002, the City, through its officials, knew, among other things, that (1) CERS's funded ratio would likely fall below the 82.3% floor set by Manager's Proposal 1; (2) the City was proposing Manager's Proposal 2 to avoid the effects of CERS's falling below the floor; (3) Manager's Proposal 2 allowed the City more time to under-fund CERS; and (4) the Blue Ribbon Committee had raised concerns about the City's under-funding of CERS and the future retiree health care liability. By early 2003, the City, through its officials, knew, among other things, that (1) the City's projected total contributions to CERS would grow from $77 million in fiscal year 2004 to $248 million in fiscal year 2009; (2) CERS had fallen below the 82.3% floor of Manager's Proposal 1; (3) the City and CERS had adopted Manager's Proposal 2 to allow the City more time to under-fund CERS; and (4) CERS was using reserved surplus earnings to pay certain benefits and to pay an increased portion of the employees' CERS contribution.

6. Materiality and the City's Voluntary Disclosure

The misleading Disclosures were material in view of the City's overall financial health. The Disclosures were also material given the magnitude of the City's projected annual CERS payments in the future and the potential consequences of those liabilities to the City, including inability to make the payments without reduction in other services.

The nature and level of under-funding brought into question the City's ability to fund the pension and health care benefits in the future as well as its ability to repay the bonds and notes. Under such a scenario, the City could be forced to choose between paying pension contributions, paying what the City owes on its bonds and notes, reducing services, and/or raising fees and taxes.

The materiality of the misleading Disclosures was demonstrated by the impact on the City's bond ratings when it finally disclosed key facts about the pension plan on January 27, 2004 in a voluntary report of information, after a non-employee CERS Board member raised concerns about the City's disclosure. The voluntary report provided information regarding (1) CERS's current and estimated future funded status; (2) the City's current and estimated future liabilities to CERS; (3) the reasons for the substantial decrease in CERS's funded ratio and increase in the City's liability to CERS; (4) the City's previous use of CERS funds to pay for retiree health care and the City's estimated future liabilities for retiree health care; and (5) the City's anticipated difficulty funding its increasing CERS contribution without new City revenues, a reduction in pension benefits, a reduction in City services, or other actions. Shortly after the disclosures in the voluntary report, the rating agencies lowered their ratings on the City's bonds and notes.

E. Legal Discussion

1. The Securities Act and Exchange Act Antifraud Provisions

State and local governments are exempt from the registration and reporting provisions of the Securities Act and the Exchange Act. Similarly, the Commission's authority to establish rules for accounting and financial reporting under Section 19 of the Securities Act and Section 13(b) of the Exchange Act does not extend to municipal securities issuers. The City and other municipal securities issuers, however, are subject to the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. In addition, the Commission has promulgated a broker-dealer rule, Exchange Act Rule 15c2-12, which in general limits market access for certain municipal securities issues to those offerings in which the issuer agrees to file annual financial disclosures of specified financial and operating information as well as notices of certain events, if material, and notices of any failures to file with repositories designated by the Commission. The antifraud rules apply to such disclosure and to any other statements made to the market.

Section 17(a) of the Securities Act prohibits misrepresentations or omissions of material facts in the offer or sale of securities. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit misrepresentations or omissions of material fact in connection with the purchase or sale of any security. These provisions prohibit the making of any untrue statement of material fact or omitting to state a material fact in the offer, purchase, or sale of securities. A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1987); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 require a showing that defendants acted with scienter. Aaron v. SEC, 446 U.S. 680, 701-02 (1980). Scienter is "a mental state embracing intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). In the Ninth Circuit, recklessness satisfies the scienter requirement. Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc). Recklessness is "an extreme departure from the standards of ordinary care, and which presents a danger of misleading [investors] that is either known to the defendant or is so obvious

that the actor must have been aware of it." Id., 914 F.2d at 1569. Scienter, however, need not be shown to establish a violation of Section 17(a)(2) or (3). Aaron v. SEC, 446 U.S. 680, 697 (1980). Violations of these sections may be established by showing negligence. SEC v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n. 5 (D.C. Cir. 1992).

2. The City's Violations of the Antifraud Provisions of the Securities Act and the Exchange Act

The City's public disclosures in the preliminary official statements and official statements for its 2002 and 2003 offerings, its 2003 continuing disclosures, and presentations to the rating agencies failed to disclose material information regarding the City's current funding of its pension and retiree health care obligations, the City's future pension and retiree health care obligations, and the City's ability to pay those future obligations. The omission of this information caused the information that was disclosed to be misleading.

This information was material to investors. The magnitude of the City's unfunded liabilities was enormous. For example, the City knew that by 2009 the unfunded liability would reach $1.9 billion and its actuarially required contribution would be approximately $240 million compared to $51 million in FY 2002. The City's under-funding of CERS and unfunded liabilities to CERS and for retiree health care were projected to continue to grow at an increasing rate. The increase in the City's under-funding and unfunded liabilities resulted, in part, from the City's decisions to increase pension and retiree health care benefits but push the costs of those increases into the future, to use CERS's prior earnings to cover additional benefits, and to pay a portion of the employees' contribution to CERS. All of this information raised a question whether the City could pay for these pension and retiree health care obligations and repay the bonds and notes issued by and on behalf of the City.

The City, through its officials, acted with scienter.[19] City officials who participated in drafting the misleading disclosure were well aware of the City's pension and retiree health care issues and the magnitude of the City's future liabilities. Moreover, even though the City officials knew that the City's pension issues were of concern to the rating agencies, they failed to disclose material information regarding the City's pension and retiree health care issues. In light of the City's officials' detailed knowledge of the magnitude of the City's pension and retiree health care liabilities and of the rating agencies' interest in those liabilities, the City officials acted recklessly in failing to disclose material information regarding those liabilities.

F. REMEDIAL EFFORTS AND UNDERTAKINGS

1. Since 2005, Respondent has implemented several remedial measures with a view to detect and prevent securities violations. Specifically, the City has terminated certain officials in the City Manager's and Auditor and Comptroller's offices or has allowed them to resign. The City has filled these positions with new employees generally having significant relevant experience with

[19] The City's scienter is based on the mental state of its officials. SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1089 n.3 (2d Cir. 1972).

other municipal governments or the private sector. The City has hired a full time municipal securities attorney who is responsible for coordinating the City's public disclosure and who has conducted continuing education for the City's deputy attorneys on the City's disclosure requirements.

2. The Mayor resigned and has been replaced by a former City police chief. In January 2006, pursuant to a public referendum, the City changed from a strong city manager form of government to a strong mayor form of government.

3. The City has hired new outside professionals including new auditors for its fiscal year audits. The City also hired individuals not affiliated with the City to act as the City's Audit Committee and charged the Committee with investigating the City's prior disclosure deficiencies and making recommendations to prevent future disclosure failures. The City has also hired new disclosure counsel for all of its future offerings, who will have better and more continuous knowledge on the City's financial affairs. This disclosure counsel has conducted seminars for City employees on their responsibilities under the federal securities laws.

4. The City has also enacted ordinances designed to change the City's disclosure environment. First, the City created a Disclosure Practices Working Group, comprised of senior City officials from across city government. The Working Group is charged with reviewing the form and content of all the City's documents and materials prepared, issued, or distributed in connection with the City's disclosure obligations relating to securities issued by the City or its related entities; and conducting a full review of the City's disclosure practices and to recommend future controls and procedures. Second, the Mayor and City Attorney must now personally certify to the City Council the accuracy of the City's official statements. Third, the City Auditor must annually evaluate the City's internal financial controls and report the results to the City Council.

5. Respondent shall comply with the following undertakings to:

a. Retain, not later than 60 days after the date of this Order, at its expense, an independent consultant not unacceptable to the Commission's staff (the "Independent Consultant"). The City shall require the Independent Consultant to (a) conduct annual reviews for a three-year period of the City's policies, procedures, and internal controls regarding its disclosures for offerings, including disclosures made in its financial statements, pursuant to continuing disclosure agreements, and to rating agencies, the hiring of internal personnel and external experts for disclosure functions, and the implementation of active and ongoing training programs to educate appropriate City employees, including officials from the City Auditor and Comptroller's office, the City Attorney's office, the Mayor, and the City Council members regarding compliance with disclosure obligations; (b) make recommendations concerning these policies, procedures, and internal controls with a view to assuring compliance with the City's disclosure obligations under the federal securities laws; and (c) assess, in years two and three, whether the City is complying with its policies, procedures, and internal controls, whether the City has adopted any of the Independent Consultant's recommendations from prior year(s) concerning such policies, procedures, and internal controls for disclosures

for offerings, and whether the new policies, procedures, and internal controls were effective in achieving their stated purposes;

b. No later than 10 days following the date of the Independent Consultant's engagement, provide to the Commission staff a copy of an engagement letter detailing the Independent Consultant's responsibilities pursuant to paragraph 5(a) above;

c. Arrange for the Independent Consultant to issue its first report within 120 days after the date of the engagement and the following two reports within 60 days following each subsequent one-year period from the date of engagement. Within 10 days after the issuance of the reports, the City shall require the Independent Consultant to submit to Kelly Bowers of the Commission's Pacific Regional Office a copy of the Independent Consultant's reports. The Independent Consultant's reports shall describe the review performed and the conclusions reached and shall include any recommendations deemed necessary to make the policies, procedures, and internal controls adequate and address the deficiencies set forth in Section III.D of the Order. The City may suggest an alternative method designed to achieve the same objective or purpose as that of the recommendation of the Independent Consultant provided that the City's Mayor and City Attorney certify in writing to the Commission staff that they have a reasonable belief that the alternative method is expected to have the same objective or purpose as that of the Independent Consultant's recommendation;

d. Take all necessary and appropriate steps to adopt, implement, and employ the Independent Consultant's recommendations or the City's alternative method designed to achieve the same objective or purpose as that of the Independent Consultant's recommendation; and

e. Require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with the City, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity; provided however, that the Independent Consultant may enter into an agreement with the City to serve as an independent monitor to oversee the City's remedial efforts with respect to enhanced accountability, greater transparency, increased fiscal responsibility, and independent oversight. Except as permitted above, the agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Pacific Regional Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with the City, or any of its present or former affiliates, directors, officers, employees, or agents acting in

their capacity as such for the period of the engagement and for a period of two years after the engagement.

6. In determining whether to accept the City's Offer, the Commission considered these undertakings and remediation measures.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the City's Offer.

Accordingly, it is hereby ORDERED that:

A. The City cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and

B. The City comply with the undertakings enumerated in paragraph 5 of Section III.F. above.

By the Commission.

Nancy M. Morris
Secretary

Exhibit 2

Ed Ryan - Incorrect Pension Materials In Bond Solicitation Circular

From: "Diann Shipione Shea" <diann@san.rr.com>
To: "Lawrence Grissom" <LGrissom@sandiego.gov>
Date: 9/5/2003 4:02 PM
Subject: Incorrect Pension Materials In Bond Solicitation Circular
CC: <dick.murphy@sandiego.gov>, "Rick Roeder" <rickro@grsnet.com>, "Fred Pierce" <Fpierce@foundation.sdsu.edu>

September 5, 2003

Mr. Larry Grissom
Administrator
San Diego City Employees Retirement System
410 B Street – Suite 400
San Diego, CA 92101

Re: Incorrect Pension Materials in Bond Solicitation Circular

Dear Larry,

It has been brought to my attention from several individuals that information regarding the San Diego City Employees Retirement System is being circulated by the Public Facilities Financing Authority of the City of San Diego regarding the soon to be sold Subordinated Sewer Revenue Bonds. The Pension materials are apparently included in the addendum. These materials appear intentionally dated and substantively incorrect, including, by example, the following:

"The actuary believes the Corridor funding method is an excellent method for the City and that it will be superior to the PUC funding method. The actuary is in the process of requesting the GASB to adopt the Corridor funding method as an approved expending method which would then eliminate any reported NPO."

The independent SDCERS Actuary indicates that these comments are, in fact, dated and taken out of context. He apparently was not asked to opine as to his current thoughts on the "Corridor funding method" which he views in a very different light than that being represented to the purchasers of these securities. Other aspects of the circulated information are likewise incorrect.

From my own reading, the materials do not provide any of the material deficit concerns even at the levels described by our staff.

As a SDCERS Trustee it is my responsibility to bring this to your attention so it can be appropriately addressed so the pension fund will not in anyway be responsible or at risk. Please provide me with written confirmation of such at your earliest convenience.

If you have any questions please contact me at 619-261-3618.

Thank you.

Sincerely,

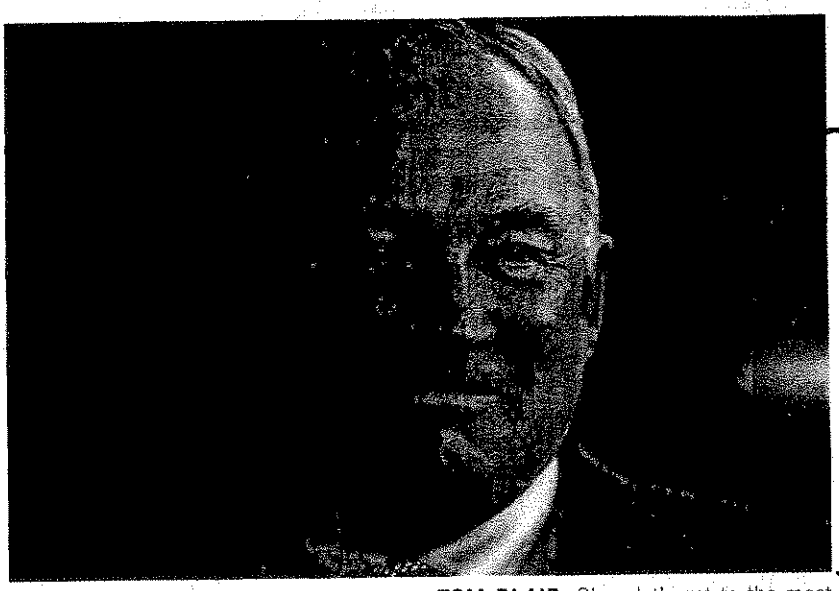
Diann Shipione
SDCERS Trustee

EXHIBIT # 73

Exhibit 3

Jerry Sanders

THE 34TH MAYOR OF SAN DIEGO, Jerry Sanders took office two years ago after winning a special election to succeed Dick Murphy, who resigned under the cloud of the city's pension crisis. Elected after promising to promote better ethics, streamline city operations and make city government more accountable, Sanders has posted a mixed record. His credentials were strong, but his tasks were Herculean. A veteran of the San Diego Police Department, he served 20 years before being promoted to chief (1993-1999). After retiring from the PD, he took over as CEO of San Diego's embattled United Way and helped turn the local charity around. Sanders lives in Kensington with his wife, Rana Sampson.



LAURA EMERY/SDU-T/ZUMA PRESS

TOM BLAIR: Okay, let's get to the most serious issue first: Are the potholes in your Kensington neighborhood as bad as the potholes in my Point Loma neighborhood?

JERRY SANDERS: You don't have any potholes in your neighborhood. But we'll be out within two weeks of any time you call.

TB: Good politics. You're coming up on two years as mayor. And you're already laying the groundwork for a reelection campaign next year. When I interviewed you before the election in 2005, you said, "The job always seems bigger than it turns out to be when you get there. But when you get there, the calm comes." Do you still believe that?

JS: Okay, the job's been much bigger than I thought it was going to be. I don't think I had a clue how complex the issues were. I don't think I had a clue about how *many* issues there were, and how difficult politics is.

TB: And yet you're ready to go another round?

JS: You get started, and you realize you can't finish everything in three years. It's important to get a lot of the stuff done that we've started. We've got a lot of people working hard on issues, and I think it's important to keep going forward.

TB: San Diego was on the brink of bankruptcy, and you inherited a horrendous mess when you moved into City Hall. Is the city in better or worse shape now?

JS: I think it's in much better shape. We've got payment schedules worked out with this five-year plan and the budget we just adopted for fixing most of the major financial issues. That's whether it's the pension system, which is on a 20-year [payback] schedule — and we're actually paying in more than we're required to — or whether it's the retiree health-care issue, which nobody had even anticipated.

TB: What's the debt there?

JS: It's $1.4 billion. We've also started putting money away for that, and we'll ramp that up significantly in the next several years. The infrastructure — you brought up the potholes — we've got a plan for $600 million over the next five years to start fixing that. Part of that is bonding, but most of it is pay-as-you-go.

TB: You say *start* to fix the infrastructure. What would it cost to fix it all?

JS: The best estimate is $700 million to $900 million — and we'll be putting in $600 million. So that's substantially reducing it to a level we can finish off. And we may even be able to expedite that, depending on property sales and some other things. When you look at those indicators, I'm confident we have things under control — at least in terms of the things we know about.

TB: Where are we on issuing new bonds?

JS: Our 2005 audit [is due very soon], and then we should be able to go back out into the market. We've been told by the rating agencies that, most likely, after they see the '05 audit, they'll reinstate our credit

EXHIBIT 47

INTERIM REPORT NO. 18

THE ADVERSE DOMINATION OF THE GOVERNMENT OF THE CITY OF SAN DIEGO

REPORT OF THE SAN DIEGO CITY ATTORNEY MICHAEL J. AGUIRRE

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE: (619) 236-6220

30 August 2007

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I.
INTRODUCTION

The City of San Diego ("City") is in the throes of one of the most daunting political and financial crises in its history. The City is currently facing a funding debt in excess of $2 billion in its pension system as a result of a number of governmental decisions including, but not limited to, the creation of illegal retirement benefits.

The granting of these benefits is the result of two contingent, *quid pro quo* arrangements between the San Diego City Council ("City Council") and the San Diego City Employees' Retirement System ("SDCERS"). The first of the deals, commonly referred to as Manager's Proposal 1 ("MP 1"), occurred in 1996 and was comprised of an agreement by the SDCERS Board of Trustees ("Board") to relieve the City from making its required payments to the pension fund. In return, the City granted retroactive retirement benefits for City employees. The second deal, called Manager's Proposal 2 ("MP 2"), took place in 2002. According to MP 2, the SDCERS Board allowed the City to pay less than actuarially required into the pension system while the City again increased pension benefits for retirees.

Ironically, throughout the late 1990s and early 2000s, the City was being honored nationwide as an example of well-managed municipalities. Meanwhile, beneath the surface the financial stability of the City was crumbling under the burden of the massive debt created by granting retroactive retirement benefits and the City's failure to pay the full actuarially required amount into the pension fund – a direct result of the MP 1 and MP 2 deals between SDCERS and the City.

City officials and high-level managers engaged in a pattern designed to conceal the debt created by MP 1 and MP 2. That pattern of concealment, as to the nature of the debt, commenced the day the first enhancements to retirement benefits were created as part of MP 1 in 1996. This pattern of concealment is still active today.

The City officials who engaged in these unlawful acts cannot be expected to police themselves and undo their own unlawful acts. Today, the City Council has four members who took part in the acts that form the basis of the wrongdoing identified herein. Thus, the government of the City of San Diego has been adversely dominated by those who engaged in this unlawful conduct and who have worked in concert with each other to frustrate all efforts to set aside the unlawful pension benefits in further violation of their fiduciary duties to the citizens of the City of San Diego.

This report explains how City officials violated their fiduciary duties to the City in granting certain pension and retiree health care benefits in violation of local and state law. This report also explains how the City has been adversely dominated by the wrongdoing of City officials, with such wrongdoing interfering and obstructing the ability of the City to set aside the illegal pension and retiree health debt. This report also shows how City officials wasted millions of dollars in attorneys and consulting fees in the effort to escape responsibility for their unlawful behavior.

Finally, this report recommends a course of action by which the City can continue to initiate appropriate action to protect taxpayers and to fulfill fundamental legal duties owed to the people of the City of San Diego.

II.
BACKGROUND

Unlawful conduct by City officials has caused the City of San Diego to suffer a staggering debt in excess of $2 billion. This debt was created when City officials and employees used unlawful means to enrich themselves with hundreds of millions of dollars of pension and retiree health care benefits in breach of their fiduciary duty to the City and the people of San Diego. In creating this debt, these officials and employees did not follow the procedures prescribed by the San Diego City Charter ("Charter") and the California State Constitution. What is worse, City officials who participated in the unlawful conduct have remained in control of the City government and have used their control to frustrate all efforts directed at repairing the damage.

As a result, the City of San Diego faces the worst financial crisis since the City was forced to declare bankruptcy in 1852.[1] As a consequence, the City's roads and streets are in disrepair,[2] City libraries and recreation centers operate at reduced schedules, neighborhood centers have closed, and capital improvements on city buildings have been postponed. It is estimated that the City's deferred maintenance and capital needs, excluding water and wastewater, is at least $800 to $900 million.[3]

On 5 September 2003, SDCERS Trustee Diann Shipione sent an e-mail to SDCERS' Administrator Lawrence Grissom warning that bond offering documents being used by the City of San Diego to sell sewer bonds were inaccurate.[4] Ms. Shipione called special attention to the statements made in the disclosure document that the SDCERS actuary had determined that the funding method being used by the City in its pension plan was "an excellent method for the City and it will be superior to the PUC method." In fact, the funding method being used was not an approved method for funding a pension

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[1] The City of San Diego operated in trusteeship under the supervision of the State of California from 25 March 1852 until 1886. See, Heilbron, Carl H. History of San Diego County (The San Diego Press Club, San Diego 1936) pp. 254-80, attached as Exhibit 1.

[2] Industry standards state that 75% of City streets should be in acceptable condition. In San Diego, however, 63% of the streets are below the national standard and are classified as being in fair or poor condition. See 2 May 2007 Mayoral Fact Sheet, Exhibit 2.

[3] 29 November 2006 City of San Diego General Fund Five-Year Financial Outlook 2008-2012 p. 25. (Exhibit 4.)

[4] 5 September 2003 e-mail from Diann Shipione, SDCERS Board Trustee, to Lawrence Grissom, administrator with SDCERS. Subject: "Incorrect Pension Materials in Bond Solicitation Circular." (Exhibit 5.)

system and was being used to hide hundreds of millions of dollars of pension benefits that had been illegally created by City officials.

Ms. Shipione's e-mail caused the City's bond offering to be halted. On 27 January 2004 the City was required to disclose to its current bond investors hundreds of millions of dollars of debt not properly disclosed by the City previously. These disclosures prompted an investigation by the U.S. Securities and Exchange Commission beginning in February 2004. On 14 November 2006, the SEC issued a cease and desist order against the City of San Diego finding that City officials had engaged in securities fraud. However, the SEC has not brought charges against any individuals as of 30 August 2007.

City officials and employees withheld from taxpayers and investors in the City's municipal bonds the massive and growing debt they caused the City to incur in order to enrich themselves. The United States Securities & Exchange Commission (SEC) after investigating the conduct of these City officials and employees found that City officials violated "the antifraud provisions of the federal securities laws."[5] The SEC made numerous findings regarding the conduct of City officials:

- The SEC found that the City of San Diego faced a "financial crisis," and in failing to disclose critical facts about its pension and retiree health care debt violated "the antifraud provisions of the federal securities laws in connection with the offer and sale of over $260 million in municipal bonds in 2002 and 2003. At the time of these offerings, City officials knew that the City faced severe difficulty funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, or City services were cut."[6] (emphasis added.)

- The SEC found the "City's looming financial crisis resulted from (1) the City's intentional under-funding of its pension plan since fiscal year 1997; (2) the City's granting of additional retroactive pension benefits since fiscal year 1980; (3) the City's use of the pension fund's assets to pay for the additional pension and retiree health care benefits since fiscal year 1980; and (4) the pension plan's less than anticipated earnings on its investments in fiscal years 2001 through 2003."[7] (emphasis added.)

- The SEC found City officials did not disclose the "gravity of the City's financial problems" including that the "City's unfunded liability to its pension plan was expected to dramatically increase, growing from $284 million at the beginning of

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[5] 14 November 2006 SEC Cease and Desist Order p. 2 ("SEC Cease & Desist Order"). (Exhibit 6.)

[6] SEC Cease and Desist Order p. 2, attached as Exhibit 6.

[7] SEC Cease and Desist Order p. 2. (Exhibit 6.)

fiscal year 2002 and $720 million at the beginning of fiscal year 2003 to an estimated $2 billion at the beginning of fiscal year 2009." Also not disclosed was the fact that the City's "projected annual pension contribution would continue to grow, from $51 million in 2002 to $248 million in 2009." Also not disclosed was the fact that the "estimated present value of the City's liability for retiree health benefits was $1.1 billion."[8]

- The SEC found that the City has used the discredited practice of applying "surplus earnings—i.e., earnings above the actuarially projected 8% return rate -- to fund an ever-increasing amount of additional benefits for San Diego City Employees' Retirement System members."[9]

- The SEC found that in "fiscal year 1996, the City agreed to increase significantly and retroactively all employees' pension benefits. The City, however, could not afford to fund the cost of the benefit increases. The City, therefore, made the pension benefit increases contingent on CERS's agreement to the City's under-funding of its annual contribution to CERS."[10] (emphasis added.)

- The SEC found that in "March 2000, the City again retroactively increased pension benefits. Specifically, the City and CERS settled a class action lawsuit brought by CERS members, with Corbett as the named class plaintiff. Under the Corbett settlement, the City retroactively gave increased pension benefits to both current and retired City employees, increasing CERS's liabilities."[11]

- The SEC found that in "April 2002, the City received a warning that the City's pension and retiree health care liabilities would continue to grow and that the City was not adequately planning to meet those liabilities." The warning, according to the SEC, came in the form of a report from "the City's Blue Ribbon Committee to the City Council."[12]

- The SEC found that in "fiscal year 2003, the City again increased its pension liability by granting additional retroactive benefits, used additional CERS assets to pay for additional pension and retiree health care benefits and an increased

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[8] SEC Cease and Desist Order pp. 2-3. (Exhibit 6.)

[9] SEC Cease and Desist Order pp. 6-7. (Exhibit 6.)

[10] SEC Cease and Desist Order p.7. (Exhibit 6.)

[11] SEC Cease and Desist Order pp. 7-8. (Exhibit 6.)

[12] SEC Cease and Desist Order p. 9. (Exhibit 6.)

portion of the employees' contribution, and obtained additional time to underfund its annual CERS contribution."[13]

- The SEC found that the City received two reports from CER's actuary that provided "the City with negative information regarding the present and projected status of CER's funded ratio and the City's unfunded liability to CERS." According to the SEC, one report showed that the pension had "suffered an actuarial loss of $364.8 million and that as of the end of fiscal year 2002, CER's funded ratio was 77.3% and the City's unfunded liability to CERS was $720 million."[14] The second report, according to the SEC, showed that the "City's contribution rate was projected to more than quadruple-9.83% of payroll in fiscal year 2002 ($51 million) to 35.27% of payroll in fiscal year 2009 ($248 million)."[15]

- The SEC found the City's financial adviser gave City officials "additional information regarding the projected growth of its future pension liabilities and the possible negative effect those liabilities would have on the City's credit rating and ability to issue municipal securities." According to the SEC, in April 2003, the financial adviser informed City officials that the "City's unfunded liability to CERS would grow to $1.9 billion at the end of fiscal year 2009 and to $2.9 billion at the end of fiscal year 2021, and CERS's funded ratio would fall to 66.5% at the end of fiscal year 2009 and would be 67% at the end of fiscal year 2021."[16]

- The SEC found that the "City, through certain of its officials, knew that its Disclosures were misleading. The Mayor and Council were responsible for approving the issuance of the bonds and notes, including issuance of the preliminary official statements and official statements."[17]

Numerous public officials were involved in the above described unlawful conduct. Between 1996 and 2002, 2 Mayors, 13 City Council members, 3 City Managers, 2 City auditors, 1 Assistant City Manager and numerous pension board members violated their fiduciary duties by creating and covering up the unlawful debt. These city officials did not follow the prescribed manner for creating city pension and retiree health care debt. *See President and Trustees of City of San Diego v. San Diego and Los* Angeles Co., 44 Cal. 106 (1872).

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[13] SEC Cease and Desist Order p. 9. (Exhibit 6.)

[14] SEC Cease and Desist Order p. 10. (Exhibit 6.)

[15] SEC Cease and Desist Order p. 10. (Exhibit 6.)

[16] SEC Cease and Desist Order pp. 13-14. (Exhibit 6.)

[17] SEC Cease and Desist Order p. 17. (Exhibit 6.)

III.
THE CREATION OF THE PENSION CRISIS

Public officials offered and received increased benefits in exchange for allowing the City to underfund the pension plan in violation of San Diego City Charter ("Charter") § 94 and Government Code § 1090. In 1996 City officials intentionally failed to pay or to require the payment of pension debt[18] in violation of Charter § 143[19] and the California State Constitution Article 16 §17,[20] increased pension and retiree health care debt without providing a means of payment in violation of the debt limit law of the California State Constitution Article 16 § 18[21] and Charter § 99.[22]

Included in the unfunded pension benefits was the DROP program that allowed City officials to receive their retirement payment while continuing to receive their salary.[23] Also included was the Purchase of Service Credit program which allowed City officials to buy up to five years of service credits.[24] Also included in these benefits was the granting of the unfunded retroactive benefits.[25]

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[18] 23 July 1996 memorandum from Larry Grissom, retirement administrator, to Cathy Lexin, labor relations manager; Subject: "*CITY MANAGER'S RETIREMENT PROPOSAL*". (Exhibit 7)

[19] San Diego City Charter §143 – Contributions. (Exhibit 8)

[20] California Constitution: Article 16 § 17 – Public Finances. (Exhibit 9)

[21] California Constitution: Article 16 § 18 – Public Finances. (Exhibit 9)

[22] San Diego City Charter § 99 – Continuing Contracts. (Exhibit 10)

[23] 4 June 1996; City Employees Retirement System (POA); "Proposal"; p.5. Management Proposal to POA – Changes to Retirement System. 4 June 1996; City Employees Retirement System (MEA); "Proposal"; p. 5. 4 June 1996; City Employees Retirement System (Local 145); "Proposal"; p. 5. (Exhibit 11)

[24] 4 June 1996; City Employees Retirement System (POA); "Proposal"; p.2. Management Proposal to POA – Changes to Retirement System. 4 June 1996; City Employees Retirement System (MEA); "Proposal"; p. 2. 4 June 1996; City Employees Retirement System (Local 145); "Proposal"; p. 2. (Exhibit 11)

[25] 4 June 1996; City Employees Retirement System (POA); "Proposal"; p.2-4. Management Proposal to POA – Changes to Retirement System. 4 June 1996; City Employees Retirement System (MEA); "Proposal"; p. 2—4. 4 June 1996; City Employees Retirement System; (Local 145) "Proposal"; p. 2—4. (Exhibit 11)

City officials held financial interests in the pension[26] debt created in 1996[27] in violation of the California Government Code § 1090[28] and Charter § 94.[29] Between 1996 and 2005 City officials priced pension service credits purchased by other City officers and employees substantially and materially below actual cost. As established under MP 1 in 1996, a key provision of the purchase of service program was that it remains cost neutral to the City. In clear violation of this provision, SDCERS Board members ignored repeated warnings from SDCERS staff and the SDCERS actuary between 1999 and 2004 that the price was too low. The SDCERS actuary went so far as to detail the debt created by the reduce pricing on the pension system. City officials, however, knowingly allowed the pricing to remain low in order to allow more employees to purchase at the discounted rate thereby plunging the pension system deeper in debt. More disconcerting is the fact that representatives of the City Council themselves purchased years of service after the SDCERS' actuary warnings.[30]

In 2000 City officials agreed to create additional pension benefits in connection with the settlement of litigation known as "Corbett" without providing a means of payment.[31] The creation of additional benefits without providing a corresponding

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[26] 1 July 2005; "Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme: Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 12)

[27] 4 June 1996; City Employees Retirement System; "Proposal"; p.5. The table presented on the bottom of page 7, titled "Employer Contribution Rate Stabilization Plan," contained a table column called "Difference $" which indicated the amount of underfunding of the pension plan that resulted in the approval of the Manager's Proposal. The table indicated that, if approved, the Manager's Proposal would lead to the underfunding of the pension plan by as much as $110.35 million between fiscal year 1996 through fiscal year 2008. (Exhibit 11)

[28] California Government Code § 1090. (Exhibit 13)

[29] San Diego City Charter § 94: Contracts. (Exhibit 14)

[30] 18 September 2006; "Interim Report No. 12: Report on Scheme to Price San Diego City Employees' Retirement System Pension Service Credits Below Cost in Violation of California Law – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 15)

[31] 17 May 2000; Superior Court of the Sate of California for the County of San Diego: Order and Judgment Approving Settlement of Class Action; "WILLIAM J. CORBET; DONALD B. ALLEN; LEORNARD LEE MOORHEAD; and GORDON L. WILSON; individually, and on behalf of all others similarly situated, Plaintiffs, v. CITY EMPLOYEES' RETIREMENT SYSTEM; and DOES 1 through 50, inclusive, Defendants. CITY OF SAN DIEGO, Real Party in Interest. (Exhibit 16)

funding source is another in violation of debt limit law contained in the California State Constitution Article 16 § 18 and City Charter § 99.[32]

In 2002 City officials intentionally failed to pay or to require the payment of pension debt[33] in violation of Charter § 143 and the California State Constitution Article 16 §17, increased pension and retiree health care debt without providing a means of payment in violation of debt limit law of the California State Constitution Article 16 § 18 and City Charter § 99, once again attempted to alter the provisions of Charter § 143 by adopting a provision which purportedly allowed the city to avoid mandatory full pension payments set by actuarial determination.[34] City officials also held financial interests in the pension debt created in 1996 in violation of the California Government Code § 1090 and Charter § 94.[35] Also included in these benefits was a provision that allowed the active members to purchase 5 years of pension credits in order to satisfy the 10 year vesting requirement.[36]

IV.
CITY OFFICIALS EDUCATED ON DISCLOSURE DUTY UNDER FEDERAL SECURITIES LAWS

City officials received a thorough explanation of their legal responsibilities to report all liabilities that could be material to investors as set forth by the federal securities

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[32] California Constitution: Article 16 § 18 – Public Finances (*see Exhibit 9*); San Diego City Charter § 99: Continuing Contracts (*see Exhibit 10*).

[33] Minutes of the 18 November 2002 meeting of the San Diego City Council; "Item-133: Two Actions related to Approval of Agreements on SDCERS Board Indemnification & City SDCERS Employer Contributions…Subitem-B (R-2003-661) ADOPTED AS RESOLUTION R-297336 – Authorizing the City to enter into an agreement with the San Diego City Employees' Retirement System regarding employer contributions." 18 November 2002; "Agreement Regarding Employer Contributions Between the City of San Diego and the San Diego City Employees' Retirement System. San Diego City Council Resolution-297336 (Exhibit 17)

[34] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18)

[35] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18)

[36] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18)

disclosure laws. This information was provided to them by lawyers from the Bryan Cave law firm in and around 6 November 2001. The information provided that the Mayor and City Council members were responsible for fully disclosing, under the federal securities laws in connection with the sale of the City's bonds, was set forth in a 29 October 2001 letter.[37] The 29 October 2001 letter to the City Council was signed by Gerald E. Boltz. Mr. Boltz.[38]

The 29 October 2001 Bryan Cave letter, authored by Mr. Boltz, informed the Mayor and City Council members that the purpose of the letter was "to provide an overview of the applicable federal securities laws" in connection with the City's 2001 lease revenue bonds.[39] The letter informed the Mayor and City Council members they "must read" the disclosure documents related to the ballpark bond offering "in light of the application of provisions of the federal securities laws."[40] The letter told Mayor and City Council members that they were required to "ask questions as to any area or matter that may seem unclear or need clarification, actively seek information from the officials of the City or Authority and professionals retained in connection with the proposed offering, and conduct follow-up as to the information supplied."[41]

The letter also clearly stated that municipal bond offerings were "not exempt transactions in municipal securities from the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder,"[42] and that the foregoing "provisions prohibit any person, including municipal issuers, from making a false or misleading statement of material fact, or

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[37] 29 October 2001 letter from Bryan Cave law firm to Leslie J. Girard. (Exhibit 19)

[38] Gerald Boltz was a highly-regarded Securities and Exchange Enforcement Division official. Mr. Boltz held several senior positions during his 20-year career at the SEC, retiring in 1979 after seven years as regional administrator of the SEC's Los Angeles Regional Office. Following his government service, Mr. Boltz became a partner in the Santa Monica, California office of Bryan Cave. *See* SEC News Digest Issue 2006-92 12 May 2006. (Exhibit 20).

[39] 29 October 2001 Bryan Cave letter. p. 1. (see Exhibit 19).

[40] The lawyers from Bryan Cave noted that allegations were made by ballpark opponents that because of various changes and alternations, the ballpark project should be re-submitted to San Diego City voters (see, 29 October 2001 Bryan Cave letter p. 1). (Exhibit 19).

[41] 29 October 2001 Bryan Cave letter p. 1-2. (Exhibit 19).

[42] *Id.* at p.2.

omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security."[43]

City officials, however, ignored the advice of Mr. Boltz and disregarded the information presented in the letter.

V.
CITY OFFICIALS CONCEAL DEBT

City officials intentionally concealed the illegally created debt from the people of the City of San Diego. Specifically:

- In 2002, City officials concealed the unlawful conduct by delaying and watering-down the findings of the City's Blue Ribbon Committee report on city finances.[44]

- In 2002, City officials agreed to indemnify pension board members in connection with the unlawful acts in which pension debt was not paid and pension benefit debt was increased without appropriate funding.[45]

- In 2002, SDCERS Board Members, which included City Official Cathy Lexin, conspired with one another to conceal that a special "Presidential Benefit" was given to incumbent union presidents under MP 2, including Ron Saathoff, President of Firefighters Local 145. Notwithstanding that this "Presidential Benefit" was negotiated as part of the retirement benefit enhancements provided for under MP 2, the provisions for the "Presidential Benefit" were omitted from the relevant labor agreements and implementing ordinances. Instead, the incumbent union president benefits were implemented in separate agreements and

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[43] *Id.*

[44] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18)

[45] Minutes of the 18 November 2002 meeting of the San Diego City Council; "Item-133: Two actions related to Approval of Agreements on SDCERS Board Indemnification & City SDCERS Employer Contributions; CITY MANAGER'S RECOMENDATION: Adopt the following resolutions: Subitem-A; (R-2003-390) ADOPTED AS RESOLUTION R-297335: Declaring that the City of San Diego agrees to defend, indemnify and hold harmless the members of the Board of Administration for the San Diego City Employees' Retirement System in performance of their duties. San Diego City Council Resolution R-297335, Adopted on 18 November 2002. (Exhibit 17)

ordinances, in order to conceal that these union presidents were receiving special additional benefits in exchange for their vote or influence to approve MP 2.[46]

- In 2002, City officials made the DROP program permanent despite the requirement set in 1996 that the DROP program could only continue if was cost neutral and despite an actuarial study showing that the DROP program was not neutral.[47]

- In 2002 and 2003, City officials violated the antifraud provisions of the federal securities laws in connection with the offer and sale of over $260 million in municipal bonds.[48] City officials knew that the City faced hundreds of millions of dollars in shortfalls for funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, and/or City services were cut.[49]

- In 2002 and 2003, in furtherance of their unlawful course of action, City officials overrode[50] the recommendation of the City's Pension Reform Committee that the

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[46] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18); San Diego City Council Resolution R-297212, adopted 21 October 2002. (Exhibit 21)

[47] 6 February 2007 City Attorney Report to the Honorable Mayor and City Council – Recommending Amendments to the SDMC Eliminating the DROP. 13 September 1999 memorandum from Rick Roeder, SDCERS actuary, entitled DROP's "Hidden" Liabilities. (Exhibit 22)

[48] 14 November 2006; United States of America before the Securities and Exchange Commission; Administrative Proceeding File No. 3-12478; In the Matter of City of San Diego, California; Order Instituting Cease-And-Desist Proceedings, Making Findings, and Imposing Cease-And-Desist Order Pursuant To Section 8A of the Securities Act of 1933 and Section 21C of the Securities Act of 1934. (Exhibit 6)

[49] 14 November 2006; United States of America before the Securities and Exchange Commission; Administrative Proceeding File No. 3-12478; In the Matter of City of San Diego, California; Order Instituting Cease-And-Desist Proceedings, Making Findings, and Imposing Cease-And-Desist Order Pursuant To Section 8A of the Securities Act of 1933 and Section 21C of the Securities Act of 1934. (Exhibit 6)

[50] LaVelle, Phillip; "City Hall pension politics heat up | Plan to scrap board may prove tricky for Murphy"; *San Diego Union-Tribune*; 4 July 2004. Minutes of the 19 July 2004 meeting of the San Diego City Council; LaVelle, Philip; "Measures to fix city pension plan OK'd | New language may force out a trustee"; *San Diego Union-Tribune*; 20 July 2004. "Tawdry Display"; *San Diego Union-Tribune*; 21 July 2004. City of San Diego:

pension board of trustees be "composed of qualified professionals who have no vested interest" in the pension plan.[51]

- In 2004 City officials carried out a plan to discredit a public official whistle blower who alleged that public officials they were engaged in on-going unlawful conduct.[52] Public officials agreed amongst themselves to place the whistle blower under arrest if she attempted to attend meetings of the pension board of which she was a member.[53]

Despite Gerald Boltz and the Bryan Cave firm's candid and straight-forward advice to City officials regarding their responsibilities to ensure the accuracy of financial statements, the City Council approved the issuance of $1.2 billion in eight separate municipal bonds from 14 February 2004 through 26 August 2003, that included false and misleading information. In approving these offerings, the City Council ignored Boltz's advice in the 21 October 2001 letter and approved both the bond offering and the associated financial statements which failed to included information about the growing liability of the pension and retiree health care plans, or the increase in debt to these programs as a result of additional benefit enhancements given to the City's municipal labor groups.

Proposition H: Prop H Amends the City Charter to Change the Composition of the Retirement Board. (Exhibit 23)

[51] 15 September 2005; Final Report of the City of San Diego Pension Reform Committee. *See Recommendation #14.* P. 20 of 74. (Exhibit 24)

[52] Whistle blower Diann Shipione sent a letter and spoke before the Mayor and City Council on 18 November 2002 noting, *inter alia*, that promising a city employee benefit conditioned upon a separate fiduciary's approval of an agreement to reduce already deficient City contributions to its pension plan is ethically questionable, if not blatantly corrupt. Shipione also clearly stated that MP 2 threatened the safety of the retirement plan. Letter from Diann Shipione to Hon. Dick Murphy and City Council, re: Items 50 & 51; re Retirement Benefits, dated 18 November 2002. Cathy Lexin, an SDCERS Board Member and the City's Labor Relations Manager, further perpetuated the concealment of unlawful acts by writing a memorandum on 6 December 2002, under the signature of then Assistant City Manager Lamont Ewell, to the Mayor and City Council responding to each of Shipione's concerns falsely concluding that "there was nothing in the process that was either improper, irregular, or unlawful, and Ms. Shipione's comments are without merit." Memorandum from P. Lamont Ewell to Hon. Mayor and City Council, Subject: SDCERS Benefit Enhancements; Response to Public Comment and Correspondence on Items 50 and 51 Adoptions Agenda, Consent Items, dated 6 December 2002. (Exhibit 25)

[53] Philip J. LaVelle, *Citizen's Arrest of Shipione Weighed*, SAN DIEGO UNION-TRIBUNE, 16 December 2004 <http://www.signonsandiego.com/news/metro/20041216-9999-1n16pension.html>. (Exhibit 26)

After the City Council chose to disregard the advice of Gerald Boltz, a former high ranking SEC official, the Council proceeded to spend millions of dollars on additional former-SEC officials to defend their actions in approving bond offerings and financial statements that failed to contain information about the declining financial stability of the City's pension system and the growing liabilities associated with retiree health care. Former-SEC officials hired by the City to defend the City Council's actions include:

- Paul Maco, the first director of the Securities and Exchange Commission's Office of Municipal Securities;
- Richard Sauer, former assistant director of the Division of Enforcement in the Securities and Exchange Commission;
- Lynn Turner, former chief accountant of the Securities and Exchange Commission;
- Arthur Levitt, former chairman of the United States Securities and Exchange Commission;
- Sean T. Prosser, a former enforcement attorney with the SEC;
- Thomas Zaccaro, former regional trial counsel for the SEC's Pacific Regional office.

The costs of these attorneys and consultants now reaches in the tens of millions of dollar purely for the defense of the City Council members and high ranking City officials. The details of their actions in San Diego are detailed further in this report.

VI.
OBSTRUCTION OF CORRECTIVE EFFORTS THROUGH ADVERSE DOMINATION

With knowledge of the prior wrongdoing from which they or their allies profited, City officials and employees used their control over City government to hamper the efforts to relieve the City and the people of San Diego from the debt. These City officials have blocked corrective action by using their control of City government to "adversely dominate" San Diego City government. See, *City of Oakland v. Carpentier* (1859) 13 Cal. 540; *Beal v. Smith* (1920) 46 Cal. App. 271, 279.

For example, in 2004, City officials attempted to cover-up their unlawful actions by hiring a law firm to give the false appearance that City officials were investigating their alleged wrongdoing. The firm, Vinson & Elkins, issued a report that, at the City's request, failed to examine key evidence. More importantly, Vinson & Elkins, throughout their engagement, reported to the San Diego City Manager, a position that was hired and fired by the San Diego City Council, the very body that Vinson & Elkins was supposed to investigate. The fact that Vinson & Elkins did not conduct a truly independent investigation caused the City's outside auditor to discount Vinson & Elkins report as insufficient as it did not meet the standards established by the American Institute of

Certified Public Accountants.[54] More alarming, the City Council voted in a closed session meeting on 21 September 2004 to permit Vinson & Elkins to begin settlement negotiations with the SEC. However, the City Council specifically stated that the City and City officials must be part of the same negotiated settlement. In other works, the City Council could not be legally separated from the City of San Diego in any settlement discussion.[55]

In 2005, City officials unlawfully obstructed the City Attorney from naming the attorney for the City's pension plan in violation of Charter § 40 and Municipal Code § 24.0910. Specifically, in 1995, the San Diego City Council adopted a resolution to allow the SDCERS Board appoint its own counsel in an attempt to establish SDCERS as a separate legal entity with interests opposed to those of the City of San Diego. This arrangement permitted the architecture and approval of the now infamous MP 1 and MP 2 deals between SDCERS and the City. These deals led to the Federal Grand Jury indictment of the SDCERS general counsel for fraud in January 2006 and the San Diego District Attorney's indictment of the SDCERS general counsel for conflict of interest and self dealing in May 2005. Despite these charges from the highest legal authorities in the County, which clearly illustrated that the 1995 City Council resolution was a failed policy, the City Council in 2005 repeatedly ignored the City Attorney's request to undo the failed resolution and allow the City Attorney to appoint the general counsel.[56]

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[54] 26 July 2006; "Interim Report No. 9: Report on Breach of Contract, Fiduciary Duties, and Professional Negligence by Vinson & Elkins LLP – Report of the San Diego City Attorney Michael J. Aguirre. (Exhibit 27.)

[55] Vigil, Jennifer; "Council asked for shield in settlement | City told its lawyers to negotiate with SEC"; *San Diego Union-Tribune;* 15 December 2005. Donohue, Andrew; "Council Tries to Settle with SEC in 2004"; *Voice of San Diego*; 14 December 2004. (Exhibit 28.)

[56] 15 December 2004 memorandum from Michael J. Aguirre to Lawrence Grissom, retirement Administrator for SDCERS; Re: "City Attorney As Legal Advisory to Board of Administration Per City of San Diego City Charter Section 40. LaVelle, Philip; "Aguirre asserts control of pension legal affairs"; *San Diego Union-Tribune;* 17 December 2004. 12 January 2005 media release from City Attorney Michael Aguirre titled, "City Attorney Reasserts Role as Chief Legal Advisor to Employees' Retirement System Amidst Allegations of IRS Violations. 22 February 2005 memorandum from City Attorney Michael Aguirre to Honorable Mayor and Members of the City Council; Subject: "Legal Action Plan to Address City's Financial Condition; Hall, Matthew T.; "Aguirre's 'road map' for S.D. | Mayor calls city attorney 'rookie' over legal advice"; *San Diego Union-Tribune;* 23 February 2005. 1 March 2005 media release from City Attorney Michael Aguirre titled, "Mayor and City Council Violate Charter; Attempt to Interfere with City Attorney Authority to Represent City's Retirement Board." (Exhibit 29.)

In 2005, City officials refused to rescind the indemnification of other city officials that purportedly obligated the City to pay for the latter's legal costs incurred in connection with the unlawful failure to pay pension debt and the granting of pension benefits without the required funding.[57]

In 2005, the Mayor refused to calendar before the City Council a discussion on the City Attorney's proposals to set aside unlawful debt created in the MP 1in 1996 and the MP 2 deal in 2002. According to the City's actuary, the removal of the illegal debt could relieve the City of San Diego of more than $500 million from it's over $1 billion pension debt.[58]

In 2006, City officials hired an individual with no pension administration experience to serve as the City's pension plan administrator.[59]

In 2006, City officials attempted to cover up their wrongdoing by employing another law firm and consulting firm to prepare a favorable report for them. However, the report failed to analyze key provisions of California's laws that deal with conflict of interest.[60]

In 2006, City Council President Peters worked with representatives of Kroll to limit questions to be asked of them during their 8 July 2006 presentation of the Kroll report to the San Diego City Council.[61] Specifically, an arrangement was established between Peters and Kroll to allow only questions regarding the contents of the report. This agreement precluded any questions regarding the adequacy and legality of Kroll's billing practices which had been called into question during the period that the company

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[57] 20 May 2005 letter from City Attorney Michael Aguirre to Honorable Mayor and City Council; Subject: "City's Illegal Agreement to Indemnify SDCERS Board Members". Gustafson, Craig; "S.D. to continue covering pension board's legal fees"; *San Diego Union-Tribune*; 19 April 2006; 30 July 2007 San Diego City Attorney Memorandum "Rescission of Resolution R-297335. (Exhibit 30.)

[58] 22 February 2005 City Attorney memorandum "Legal Action Plan to Address City's Financial Condition, Exhibit 31.

[59] 26 September 2006 Deposition of David B. Wescoe pp. 47-48, (Exhibit 32.)

[60] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (See Exhibit 8) 13 April 2006; "Interim Report No. 8 Report on Kroll's Breach of Legal Duties Owed to the City of San Diego, Exhibit 33.

[61] Matthew T. Hall, *Kroll Report, Quarreling Both Have Early Start: Details of 8a.m. Meeting Next Week Upset Leaders*, SAN DIEGO UNION-TRIBUNE, 3August 2006. (Exhibit 34.)

worked on the report. This agreement also precluded any questions regarding the investigative methods and techniques used by Kroll to ensure they met standards established by the American Institute of Certified Public Accountants.[62]

In 2006, the Council President refused to calendar a discussion before the City Council on the City Attorney's proposal for setting aside the unlawful debt.

In 2006, the San Diego City Employees' Retirement System pension actuary refused to answer questions regarding his actuarial report which contained questionable assumptions that had the effect of understating the sums due.[63] This is crucial because, at this time, the City was on notice that it was under investigation by the U.S. Securities and Exchange Commission. In short, while being investigated, the SDCERS general counsel, with the assistance of City Council President Scott Peters, precluded a due diligence questioning of the adequacy of the financial information to ensure that the accurate financial information was being issued to the public and to investors in San Diego bonds.

In 2007, despite a mandatory vote of the people of San Diego,[64] the SDCERS board decided to use a 20-year amortization period rather than the voter mandated period of 15 years.[65] Despite the clear voice of the people, the Mayor's appointee on the board

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[62] It is worth noting that the City of San Diego has received detailed billings from Kroll to audit the work and ensure that the City was not over billed for work or that the City was billed for work that was not completed.

[63] Jennifer Vigil, *Pension Board Rejects Aguirre's Questions*, SAN DIEGO UNION-TRIBUNE, 20 May 2006; Craig Gustafson, *Council Panel Questioning Actuary on Pension Gap*, SAN DIEGO UNION-TRIBUNE, 15 June 2006, Exhibit 36.

[64] On 2 November 2004, 53.41% of San Diego voters approved Proposition G to enforce certain changes on the amortization schedule for paying of liabilities for the San Diego City Employees' Retirement System. The ballot language of Proposition G stated, "This proposition would preclude the ability of the City of San Diego to negotiate multi-year delays of full actuarial funding of the Retirement System. Additionally, the basis upon which new retirement benefits are amortized would be limited to no more than a five-year schedule and the basis upon which net accumulated actuarial losses are amortized would be limited to no more than a fifteen-year schedule." (Exhibit 23.)

[65] Vigil, Jennifer, "Payment span set on pension debt," *San Diego Union-Tribune,* 17 March 2007. (Exhibit 37.)

voted in favor of this provision.[66] As a result, the City officials violated the San Diego Charter.[67]

Council President Scott Peters further illustrated his unwillingness to comply with the rule of law established by the SEC Cease-and-Desist Order when he issued a letter on 2 August 2007 to Mayor Sanders seeking certain changes to the City's financial statements. Most disconcerting is that the some of the changes include glaring misstatements of facts that Mr. Peters of issues that he is aware of. Specifically, Peters asked that the new CAFR include information that the voters approved a 15-year amortization schedule for the unfunded liability of the pension debt.[68] Peters made this suggested after he was aware that the SDCERS Board voted to implement a 20-year amortization schedule for the debt.

In 2007, City officials and employees agreed to carry out a false and misleading campaign to pressure the City Attorney to drop the City's legal actions to set aside the unlawful debt.[69]

In 2007, the San Diego City pension actuary refused to answer questions regarding his actual report which contained questionable assumptions that had the effect of understating the sums due.[70]

In 2007, City Councilmember Toni Atkins blocked discussion of the need to correct the underlying unlawful conduct by withdrawing from the San Diego City Audit Committee thereby depriving the Audit Committee of a quorum.[71]

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[66] Vigil, Jennifer, "Payment span set on pension debt," *San Diego Union-Tribune,* 17 March 2007. The article stated, "The pension board approved the 20-year time frame on a 9-3 vote, with three representatives of employee unions dissenting...." (Exhibit 37.)

[67] San Diego City Charter § 143 (see Exhibit 8.)

[68] 2 August 2007 letter from Council president Scott Peters to Mayor Jerry Sanders. Subject: "2004 Comprehensive Annual financial Reports". (Exhibit 38.)

[69] 6 August 2007 email from Debbie Quinones; Subject: "Urgent Message From MEA." (Exhibit 39.)

[70] 12 April 2007 City Attorney Media Advisory City Attorney Responds to City Council President's Action to Suppress Public's Right to Know About Pension Issues; 11 April 2007 Letter from Scott Peters to David Wescoe, Exhibit 40.

[71] See 6 August 2007 Audit Committee Meeting Video Archive, at minute 24:15-24:45 <http://granicus.sandiego.gov/ViewPublisher.php?view_id=24>

VII.
ADVERSE DOMINATION EXPLAINED

As stated above, certain San Diego City officials and employees have used their power to disrupt the efforts to undo the unlawful debt they created in order to benefit themselves and their political supporters at the expense of the City. The actions of these officers and employees violate the fundamental principle that officers of a municipal corporation are agents of the corporate body, and may not use their official position for their own benefit, or for the benefit of any one except the municipality itself. *People v. Sullivan*, 113 Cal. App. 2d 510, 523 (1952).

When a corporation, like the City of San Diego, is adversely dominated by its board, courts have refused to allow a City's cause of action against its board of directors to expire as long as the board remained in control of the corporation, thus precluding the running of the statute of limitations. *See Adams v. Clark*, 22 F.2d 957, 959 (9th Cir. 1927); Michael E. Baughman, Comment, *Defining the Boundaries of the Adverse Domination Doctrine: Is there Any Repose for Corporate Directors?*, 143 U. Pa. L. Rev. 1065, 1066 (1994-95).

California courts follow this principle, as there exists a long line of case authority supporting the adverse domination principle to toll statutes of limitations so long as a corporate board remains in the hands of wrongdoing directors. As stated in *Whitten v. Dabney*, 171 Cal. 621,629 (1915):

> So long as the corporation itself remains under disability and is powerless to act by virtue of the fact that its control is in the hands of a board of directors accused of participation in the frauds the statute of limitations does not run against it.

In *Dabney*, stockholders sued alleging a conspiracy to defraud future stockholders by three corporate founders who were said to control the Dabney Oil Company through the board of directors. *Id.* at 623-24. The conspirators were alleged to have transferred leaseholds of oil lands in exchange for stock in the company. The trio offered stock to the public claiming it was treasury stock and that the proceeds from the sale of the stock would go into the treasury of the Dabney Oil Company and be used in developing its oil mining opportunities. *Id.* at 624-25. To stimulate sales of the stock, false dividends were declared and paid, not out of the earnings of the company, but out of the proceeds of the sale of stock. Dabney and his cohorts also failed to pay back large amounts of money owed the company but instead caused false credits to be entered upon the books of the corporation. Unauthorized commissions were paid by the wrongdoers. They also made false written representations. *Id.* at 626-27. In short, the defendants were alleged to have engaged in a stock jobbing scheme, in which they made quick buys and sales of company stock with the intent of artificially increasing the market price of the company's stock. *Id.* at 626-27.

The Court in *Dabney* likened a corporation controlled by law violating directors to the "minority of an infant." The rights of the corporation, like the minor, "are not lost until he, after attaining majority, acquiesces for the prescribed time and by acquiescence affirms the acts done against his interests." The Court in *Dabney* went on to explain that even if a complaint as "shows that the plaintiff stockholder has waited too long before commencing his action, and that therefore the plea of the statute of limitations must be sustained against his action, this does not operate as a bar to the corporate rights when prosecuted by another stockholder." The *Dabney* court explained that "[o]therwise we would have the anomalous and absurd condition presented of a complacent stockholder waiting for three years, pleading facts showing that his right of action was thus barred, and thus sweeping away every right of the corporation by the judgment which would have to follow." *Id.* at 629-30.

The California Supreme Court applied the adverse domination principle to suspend the statute of limitation for the City of Oakland in 1859. *City of Oakland v. Carpentier*, 13 Cal. 540 (1859). In that case the California Supreme Court stated that so long as the municipal corporation remained under the domination of "confederates" engaged in an unlawful scheme the statute was tolled:

> If these facts be made to appear, the statue of limitations would not begin to run until after the corporation thus defrauded got out of the hands of the confederates, and an opportunity were afforded innocent agents, coming to the management of the affairs of the town, to look into and ascertain the true state of things. Knowledge on the part of the guilty agents of the corporation of the criminal fact is not notice to the corporation of such fraud, so as to give the advantage of this notice to the equally guilty associate of those agents. If this were the law, an agent could always protect himself by joining in a conspiracy to defraud his principal with a convenient friend, who received the principal's property, and who might claim against the principal that the agent had notice of the fraud.

Id. at 552.

The facts of *Oakland v. Carpentier*, are instructive. The complaint sought to set aside a franchise and real estate lease made by the Board of Trustees of the City of Oakland in 1854 with a prominent private citizen of Oakland, Horace W. Carpentier. The City of Oakland "pretended to convey" to Carpentier and his representatives "the exclusive right and privilege of constructing wharves, piers, and docks, at any point within the corporate limits of the town of Oakland, with the right of collecting wharfage and dockage as he might deem reasonable, upon certain conditions expressed in the ordinance." *Id.* at 543-44.

The complaint further alleged that after receiving the pretended conveyance of real estate and franchises, Carpentier "by fraud, procured certain men to be elected again as the Board, who ratified this contract; that the first ordinance was fraudulent, Carpentier

having procured himself to be elected Trustee for the purpose of getting it and having his agents on the Board of Trustees." *Id.* at 544.

Carpentier was alleged to have received from the City of Oakland trustees "the sole privilege, not only of constructing all wharves, but of laying out, establishing, and regulating them, too. This amounts, not to the grant of a license or privilege to erect a wharf, or all the wharves, laid out or ordered by the council, but the grant of an exclusive right to lay out and construct them at his own convenience, in his own way, and to hold and use them on his own terms; and, if he did not choose to exercise this privilege, the corporation is prevented from giving the privilege to any one else; and so of docks, piers, and the like." *Id.* at 545-46.

The Court found the ordinance was not "an exercise of a power under the charter, but as a transfer of the corporate powers intrusted to this Board to this favored grantee." *Id.* at 546. In order to carry out the extraordinary grant of public rights Carpentier was alleged to have "procured men, who were his agents or conspirators with him, to be elected to this Board, for the purpose of getting them to defraud the town, for his benefit, of all this property and these franchises." *Id.* at 551.

Carpentier was also alleged to have in essence "got himself elected to this place, in order to help the contrivance through, whether by his influence, or by keeping out some one else who might have opposed the scheme, then this was sufficient to brand the whole transaction with illegality." *Id.* at 551. If "Carpentier put himself in the position of a member elect of this Board, neither resigning nor qualifying, and took advantage of this position to advance his personal interests, at the expense of those of the corporation, this was a fraud for which a Court of Equity would hold him responsible." *Id.* at 551-52. The Court explained that Carpentier occupied "the position, really, of a Trustee dealing for his own profit with the subject of the trust, and his conduct would be scrutinized with the jealousy with which equity regards the interested dealings of an agent with the principal, in respect to the subject of the trust." *Id.* at 552.

The Court was careful to note that ratification would have no "effect in validating the transaction" by "a subsequent Board, if the members were fraudulently elected, or procured to be elected, by Carpentier." *Id.* at 552. The Court explained that "Carpentier could not protect his fraud by the sanction of his own associates united to effect, together, an illegal enterprise." *Id.* at 552. The Court then went on to find the allegations of adverse domination would be sufficient to toll the statute of limitations until innocent agents took over the management of the City.

In another California case issued eight years before *Whitten v. Dabney*, the Court in *Pacific Vinegar and Pickle Works v. Smith*, 152 Cal. 507 (1907), traced the authority for the proposition that knowledge was not to be imputed to the corporation by its wrongdoing officers and agents. The court explained that to do so would allow an officer or agent of the corporation to enforce his own wrong against his principal:

> It would permit an officer of a corporation to enforce his own wrong against the corporation itself. Thus, while this rule of imputable knowledge of the contents of the books of a corporation is presumed for the protection of third persons and stockholders, it is not only never recognized, but distinctly disaffirmed, where the matter complained of is one between the corporation itself and any of its officers or agents. To apply it, would be to put a premium on dishonest bookkeeping, and, as pointed out by Mr. Justice Brewer, in the case of a bank, to permit the bookkeeper and cashier to combine and plunder the bank of all its assets, unknown to any one, through every transaction should be entered in the books, and, after doing this, to receive immunity because of the knowledge imputed to the other officers.

Id. at 514.[72]

Beal v. Smith, 46 Cal. App. 271 (1920) followed the rule established in *Whitten v. Dabney*. In *Beal*, the court reiterated the rule that when the board of directors is under the domination of those who are committing fraud, the limitation period for commencing suit is tolled:

> But where, as alleged here, the corporation and its board of directors were wholly under the domination of those who committed the original fraud the corporation is deemed to be in the same position as an incompetent person or a minor without legal capacity either to know or to act in relation to the fraud so committed, and during such period of incapacity the statute of limitations does not run, at least, against an innocent stockholder who was without knowledge of the fraud.

Id. at 279.

San Leandro Canning Co., v. Perillo, 211 Cal. 482 (1931) also followed the rule established in *Whitten v. Dabney*, *Pacific Vinegar and Pickle Works v. Smith* and *City of Oakland v. Carpentier*. In *San Leandro*, the limitations statute was tolled based upon fraudulent acts of the directors:

> [T]he cause of action set forth in the plaintiff's complaint was not barred at the time of the commencement thereof by any statute of limitations. The unexpressed reason for this ruling was doubtless that set forth in the complaint, to the effect that during the course of the transaction out of which this controversy arose and for a period of time up to within three

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[72] The *Pacific Vinegar* court based its holding that guilty knowledge of agents of a corporation is not attributable to the corporation on three cases originating outside of California: *Scott v. De Peyster*, 1 Edw. Ch. (N.Y.) 513; *Wakeman v. Dalley*, 51 N.Y. 27; and *Wallace v. Lincoln Savings Bank*, 89 Tenn. 630.

> years prior to the date of the commencement of the action the defendants were the directors of said corporation, and as such were in the full control of its affairs and finances. These averments of the complaint having been for the purposes of said decision taken to be true, it would follow, under what we deem to be a well-settled principle of law, that the statute of limitations does not commence to run against unlawful acts and expenditures made by or under the direction of the directors of the corporation while they were in full control of its affairs and of the expenditures of its funds.

Id. at 486-487. (Emphasis added.)

The adverse domination on one level is but an extension of the basic rule of agency law to the effect that knowledge of agents acting adversely to their principal is not imputed to the principal:

Where an agent acts in a capacity adverse to the principal in the transaction, there is no reason to believe that the agent will keep the principal properly informed, and ordinarily the notice will not be imputed. This rule is, in a sense, derived from the broader principle that knowledge of the agent obtained while acting contrary to or outside the scope of his or her authority will not be imputed. Witkin, Agency and Employment § 155; *See Los Angeles Inv. Co. v. Home Savings Bank of Los Angeles*, 180 Cal. 601 (1919); *Sands v. Eagle Oil & Refining Co.*, 83 Cal. App. 2d 312, 319 (1948); Rest. 2d, Agency §§ 282, 279, and Appendix, Re. Notes, pp. 478, 485.

In order to establish that the management of a city is adversely dominated by wrongdoers, the question of the degree to which the domination exists has to be resolved. Michael E. Baughman, Comment, *Defining the Boundaries of the Adverse Domination Doctrine: Is There Any Repose For Corporate Directors?*, 143 U. Pa. L. Rev. 1065 (1994-95). The source of the modern adverse domination claim is *International Railways of Central America v. United Fruit Co.*, 373 F.2d 408, 414 (2d Cir. 1967):

> One principle emerging with some clarity is that a plaintiff who seeks to toll the statute on the basis of domination of a corporation has the burden of showing a full, complete and exclusive control in the directors or officers charged. (Citation omitted.)

The version of adverse domination taken from the *United Fruit* case is known as the "complete domination test." See *Federal Deposit Ins. Corp v. Dawson* 4 F.2d 1303, 1309 (5th Cir. 1993); Michael E. Baughman, Comment, *Defining the Boundaries of the Adverse Domination Doctrine: Is There Any Repose For Corporate Directors?*, 143 U. Pa. L. Rev. 1065, 1082 (1994-95). Complete domination is an issue of fact, not merely a numerical question. In *Farmers & Merchants National Bank v. Bryan*, 902 F.2d 1520 (10th Cir. 1990), the court was asked to find that adverse domination did not apply as a matter of law because there were two outside directors on the board who were not accused of wrongdoing. The *Bryan* court held that the question of domination is one of

fact for the jury to decide, and noted that "a plaintiff may also demonstrate adverse domination by proving that an informed director, though capable of suing, would not do so." *Id.* at 1523. Another court applying the "complete domination test," has further held the doctrine of adverse domination is "inherently fact-specific" and that "control sufficient to warrant the tolling of the statute of limitations may occur where culpable directors constitute less than a majority of a board of directors . . . ." *Resolution Trust Corporation v. Thomas*, 837 F.Supp. 354, 359 (D.Kan. 1993).

However, as one commentator has noted, the trend of adverse domination is toward applying a "majority test," in which a plaintiff "must show only that a majority of the board members were wrongdoers during the period the plaintiff seeks to toll the statute." *Federal Deposit Ins. Corp. v. Dawson* 4 F.2d 1303, 1310 (5th Cir. 1993). In adopting the majority test, the Court in *Dawson* reasoned that "the mere existence of a culpable majority on the board is so likely to preclude the corporation from filing suit against the wrongdoers that tolling is thereby justified." *Dawson,* 4 F.2d at 1310. The majority test is exclusively a numerical one and has been adopted by most courts. Michael E. Baughman, Comment, *Defining the Boundaries of the Adverse Domination Doctrine: Is There Any Repose For Corporate Directors?*, 143 U. Pa. L. Rev. 1065, 1082 (1994-95).

VIII.
PUBLIC OFFICIALS HAVE FORGOTTEN GOVERNMENT ESTABLISHED TO SERVE THE PEOPLE

City officials and employees have deviated so far from their fundamental duties to the people of San Diego that it is necessary and useful to review the fundamental purpose of local government. San Diegans, like Americans in general, have always acted upon the deep-seated conviction that local matters can be better regulated by the people of the locality than by the state or central authority.

One controlling idea of local self-government is to bring the officials nearer to the people whose interests are immediately affected by official conduct, in deference to the fundamental maxim in the American system of government that the nearer the officers are to the people they represent, the more easily and readily are reached the evils that result from political corruption and the more speedy and certain the cure. Local self-government is, thus, a guaranty of individual liberty. *Penhallow v. Doane*, 3 Dall 54, 93, 1 L Ed 507 (1795); 1 McQuillin Mun. Corp. § 1.44 (3rd ed.)

However, the right of the people of San Diego to participate in fundamental decisions made by their City officials and employees has been frustrated by the course of illegal conduct described in this report. As a consequence, in the operation of San Diego's local self-government, the public has been alienated from their City government. It is hoped that a candid discussion of the issues in this report will help to awaken the public to take an active hand in redressing the crisis faced by their local government. 1 *McQuillin Mun. Corp. §* 1.37 (3rd ed); *See* Gerald E. Frug, *The City as a Legal Concept*, 93 Harv. L. Rev 1059 (1980).

It is important to remind San Diego City officials and employees that under our form of government, the repository of ultimate sovereignty is in the people. *Adkins v. Children's Hospital of the District of Columbia*, 261 US 525, 544 (1923); 1 McQuillin Mun. Corp. § 1.44 (3rd ed.). The people in political and legal theory are the supreme law-givers, law-interpreters, and law-administrators. In them resides the law-making, law-interpreting and law-enforcing power. No officer, agent or department can run counter to the public will unless and until a change in that will is reflected by a change in the Constitution. 1 McQuillin Mun. Corp. § 1.44 (3rd ed.). (Emphasis added.)

IX.
THE FIDUCIARY DUTIES OF PUBLIC OFFICIALS

It is universally agreed that local government officers owe their government, and the people of their city, a fiduciary duty of the highest possible fidelity and of the greatest skill and diligence as to their work. Osborne Reynolds, Jr., *Local Government Law* § 84 p. 293 (2d ed.); *Terry v. Bender*, 143 Cal. App. 2d 198 (1956). In discharging their duties, city officers may not go beyond the law. McQuillin Mun Corp § 12.126 p. 599-600 (3d ed); *Kennedy v. Ross*, 28 Cal 2d. 569 (1946); *Bolger v. San Diego*, 239 Cal. App. 2d 888 (1966); *Powell v. San Francisco*, 62 Cal. App. 2d 291 (1944). The principles within which city officers operate are set by law:

> These rules are firmly established and uniformly enforced by the courts: municipal officers are only agents of the local public in its corporate capacity, they act under defined powers and duties, limited and restricted by law, and the extent of these powers is to be strictly construed and may not be enlarged by usage or custom.

McQuillin Mun Corp § 12.126 (3d ed.) p. 601; *People v. Sullivan*, 113 Cal. App. 2d 510 (1952).

San Diego's charter and California State law forbids City officers from being directly or indirectly interested in any contract with the city. San Diego City Charter § 94; Cal. Gov't Code §§ 1090, 1092; *Thomson v. Call*, 38 Cal 3d 633 (1985); *Berka v. Woodward*, 125 Cal. 119 (1899); *Imperial Beach v. Bailey*, 103 Cal. App. 3d 191 (1980); 3 McQuillin Mun. Corp. § 12.136 (3d ed.) The general rule is that there should be strict enforcement of conflict of interest statutes so as to provide a strong disincentive for officers who might be tempted to take personal advantage of their public offices. 3 McQuillin Mun. Corp. § 12.136 (3^{d} ed.)

City officials' ability to create debt in the name of the City is restrained by debt limitations contained in the San Diego City Charter and the California State Constitution. San Diego Charter § 99 and California Constitution Article 16 § 18 require a vote of the people for debt or liabilities incurred in any one year that exceed that year's revenue.

These debt limit provisions are intended to prohibit the accumulation of public debt without the consent of the taxpayers, and require governmental agencies to carry on their operations on a cash basis. In re *Southern Humboldt Community Healthcare Dist.*, 254 B.R. 758 (Bankr. N.D. Cal. 2000); 56 Am.Jur.2d, Municipal Corporations, Counties, and Other Political Subdivisions, § 606. Claims made on loans in excess of borrowing limitations are unenforceable. 64A C.J.S., Municipal Corporations, § 1599, citing, *inter alia, City of Los Angeles v. Offner*, 19 Cal.2d 483, 486 (1942); *see also* 15 McQuillin Mun. Corp. § 41:1 (3d ed.)

Debt-limitation provisions are designed to promote the common good and welfare. In re *Southern Humboldt Community Healthcare Dist.*, 254 B.R. 758 (Bankr. N.D. Cal. 2000); 15 McQuillin Mun. Corp. § 41:1 (3d ed.) Their purpose to serve as a limit to taxation and as a protection to taxpayers; to maintain municipal solvency, to keep municipal officials from abusing the taxpayers' credit, and to protect them from oppressive taxation. 15 McQuillin Mun. Corp. § 41:1 (3d ed.) Moreover, these debt limit laws seek to prevent current councils from binding future councils, and to prevent today's legislators from making future taxpayers pay today's bills. As Thomas Jefferson once stated "...public debt (is) the greatest of dangers to be feared." 15 McQuillin Mun. Corp. § 41:1 (3d ed.)

Specifically, California Constitution Article 16 § 18 provides that no city "shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters." San Diego City Charter § 99 provides that the "City shall not incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year unless" approved by City voters.

When a San Diego City public official negotiates a City contract in which they hold a financial interest they violate Government Code § 1090 and Charter § 94. When a city official agrees to indebt the City in excess of available same year revenues he violates Charter § 99 and the California State Constitution Article 16 § 18.

X.
EFFORT TO SETASIDE UNLAWFUL PENSION DEBT

Between 2005 and 2007 the City Attorney issued a series of Interim Reports detailing the unlawful acts of city officials related to the unlawful pension debt and efforts to hide and cover-up the nature and extent of the related problems created for the City.[73] On July 8, 2005 the City Attorney, on behalf of the City of San Diego, filed in San Diego Superior Court a cross-complaint directed at setting aside the unlawful pension debt. The matter was assigned to the Honorable Jeffrey B. Barton.

[73] Go to www.sandiegocityattorney.org Investigative Reports

In addition, the granting of illegal benefits and the intentional underfunding of the pension system has generated numerous lawsuits in which the City has been involved. These lawsuits can be separated into several categories, lawsuits brought by the City, lawsuits against the City and taxpayer initiated lawsuits.

In the first category, lawsuits brought by the City, the City has brought lawsuits against several of the professionals paid to render competent advice to the City and SDCERS regarding the operation of the pension fund, but who failed to competently render the advice paid for. Defendants in these actions include Callan & Associates, who were involved in the bond issuance, Gabriel, Roeder, Smith & Company, SDCERS' former actuary, Caporicci and Larson, an audit firm, and Calderon, Jaham & Osborn, another audit firm. Monetary recoveries from some of these cases have netted the City in excess of $6,000,000, with several other cases still pending.

In other pension related lawsuits, the City has been sued. Specifically, in the case before Judge Barton, SDCERS initiated this action when it sued the City. In this lawsuit, the City has asserted a cross-complaint seeking a determination of whether or not the agreements known as Manager's Proposal 1 and Manager's Proposal 2 are legal. Manager's Proposal 1 and Manager's Proposal 2 are the agreements between the City and SDCERS in which SDCERS agreed to allow the City to intentionally underfund the pension system in exchange for the City agreeing to increase pension benefits retroactively and prospectively.

Other lawsuits, in which the City has been named as the defendant, include the federal cases brought by the San Diego Police Officer's Association against the City. In these lawsuits, the SDPOA complained that the City was not providing the police officers with an actuarial sound pension system. Judge Huff has dismissed all the federal claims brought by the SDPOA as being unmeritorious.

Last, taxpayers have sued the City with regards to pension issues. The two most notable cases are the ones that were brought by Jim Gleason and William McGuigan. In these two cases, both sought relief the City's decision to intentionally underfund the pension system. Both of these cases were settled after the City agreed to contribute additional funds to the pension system.

In the course of the litigation the City Attorney's office responded to 6 demurrers, and 3 summary judgment/adjudication motions. The City brought its own summary judgment motion. In addition the City filed 2writs to the State Appellate Court and 1 writ to the California Supreme Court.

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XI.
OPTIONS FOR CITY OF SAN DIEGO TO SETASIDE UNLAWFUL DEBT

A. APPEAL

The City Attorney's office is pursuing and proposing several options for undoing the illegal pension and retiree health care debt.[74] The City is appealing Judge Jeffrey B. Barton's ruling dismissing the City's Cross-complaint on several grounds. First, the City believes that Judge Barton read the law prohibiting City officials from negotiating contracts in which they have a financial interest (Government Code § 1090) too narrowly. The Court found that even if officials were involved in the original violations Government Code § 1090, those violations were waived by later contracts in which some of the same officials participated. The City believes that the only way that a Government Code § 1090 violation can be corrected is after full disclosure and vote by a disinterested board.

The City also believes the Court ignored clear decision of the legislature to set a four year from the date of discovery statute of limitations for Government Code § 1090 actions. The Court found that a one year statute applied. The Court also erred in ruling that anyone affected by an order to set aside the contracts creating the illegal debt because they violated Government Code § 1090 would have to be personally named in the case. The City believes fundamentally that Judge Barton's narrow reading of Government Code § 1090 was inconsistent with decades of judicial precedent.

Further, The City also believes that Judge Barton erred in refusing to resolve whether the liability limit law had been violated in connection with the creation of the pension debt. The Court misstated the City's theory in ruling that the liability limit law did not apply to the pension board. The City's case was based upon the theory that there was a dispute between the City and the pension board over whether City officials in creating the pension debt violated the liability limit law.

B. COUNCIL ACTION TO RESCIND ILLEGAL DEBT

The City Attorney recently proposed an additional step the City could take to set aside the illegal pension debt. Judge Barton has ruled that the City's action to set aside the unlawful pension debt was not properly presented before the court. However, the City Attorney proposed in a memorandum of 10 August 2007 that the Council take action that would join the issue of whether the debt was created in violation of the liability limit law. These recommendations by the City Attorney included, among others, that the Council take the following actions:

1. Rescind, as void and in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, and Article XVI, Section

[74] See City Attorney proposal for resolving the pension crisis. (See Exhibit 31.)

18 of the California Constitution, the retroactive portion of the "2.0% at 55" pension increase for all general employees and the "2.5% at 50" pension increase to all safety employees who received such retroactive increase as part of Manager's Proposal 1 ("MP 1")[75] and the "2.5% at 55" pension increase for all general employees and the "3.0% at 50" pension increase Manager's Proposal 2 ("MP 2")[76], except that members who retired after such retroactive increase took effect shall not be required to repay any pension payments representing the retroactive increase that they have actually received, but shall only be ineligible to receive payments attributable to such retroactive increase going forward;

2. Rescind, as void and in violation of Article XVI, Section 6, Article IV, Section 17 and Article XI, Section 10(a) of the California Constitution the DROP program following its initial three year trial period. DROP was intended to be a cost-neutral program. DROP was proven to be a non-cost neutral program prior to the expiration of its three year trial period. Its continuation following the three year trial period in which it guarantees its participants an 8% return compounded quarterly even after the participant has left City employment and the DROP program constitutes an illegal gift of public funds.

3. Rescind, as void and in violation of Article XVI, Section 6, Article IV, Section 17 and Article XI, Section 10(a) of the California Constitution the purchase of service program. The purchase of service program was intended to be a cost-neutral program. However, SDCERS set the price for the purchase of service of credits at an arbitrary value, with said purchase price being way too low. The arbitrarily low price was eventually increased, but only after, the public employees were informed that the price was

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[75] The multiplier increases under MP 1 were dependent on age. The retirement multiplier for general members started at 2.0% at age 55 and went up to 2.55% for anyone retiring at age 65 or greater. Safety members (excluding lifeguards, who had their own separate sliding scale) multiplier began at 2.5% at age 50 and went up to 2.99% at age 56 and above. Lifeguards multiplier started at 2.20% at age 50 and went up to 2.77% at age 56 or above. Thus, when this memo discusses the pension increases granted under MP 1, the author is referencing all the multiplier increases contained within MP 1.

[76] The multiplier increases under MP 2 were dependent on age. The retirement multiplier for general members started at 2.5% at age 55 and went up to 2.8% for anyone retiring at age 65 or greater. Safety members, including lifeguards, multiplier was increased to 3.0% at age 50 and above. Thus, when this memo discusses the pension increases granted under MP 2, the author is referencing all the multiplier increases contained within MP 2.

below the system's cost and encouraged to buy the maximum amount of service credits before the price was increased. The purchase of service allows a retiring member (including a member in DROP) to receive pension benefits that were not fully paid for by the employee, but rather, is being subsidized by the City. The amount the City now needs to contribute to fund the purchase of service annuity for each member who purchased service credits at below cost constitutes an illegal gift of public funds.

4. Direct the City Attorney to immediately file a Declaratory Relief action in the San Diego County Superior Court against each of the City's unions and the San Diego City Employees' Retirement System ("SDCERS"), confirming the rescission, seeking a judicial declaration that (1) the retroactive portion of the pension increases violates the debt limitation provisions, is a gift of public funds, and is extra compensation paid to public employees, all in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, and Article XVI, Section 18 of the California Constitution, (2) the DROP program's continuation after its initial three year trial period is a gift of public funds, and is extra compensation paid to public employees, all in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, (3) the purchase of service program is a gift of public funds, and is extra compensation paid to public employees, all in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, (4) that the City of San Diego has no obligation to make any further payments toward the retroactive portion of the pension increase, and enjoining further payments by SDCERS of the portion of payments to retirees based on the retroactive portion, (5) that the City of San Diego may discontinue the DROP program, and (6) that the service credits purchased prior to July 2005 be marked down to their actual value; and

5. Direct the City Attorney to send a letter to the Chief Executive Officer of SDCERS informing him that the City Council considers the retroactive portion of the pension increases to all members pursuant to MP 1 and MP 2 unconstitutional and void, that the City of San Diego will not include as its future payments the retroactive increase, requesting that SDCERS immediately calculate the required future payments based on the rate prior to the enactment of MP 1, the rate following MP 1 and prior to MP 2 and the rate following MP 2, that the City is discontinuing the DROP program and that service credits purchased prior to July 2005 be marked down to actual value.

6. Following enacting the appropriate legislation to rescind these benefits, stay enforcement of the rescission of the retroactive benefits, the DROP program and the mark down of the purchased service credits for sixty days so that any interested party can challenge the legality of the rescission in a court of competent jurisdiction.

C. AWAIT A NEW CITY COUNCIL

A new City Council will be elected by November 2008. A new City Council made up of members who did not participate in the unlawful conduct by which the illegal pension and retiree health care debt was created will be more inclined to take the action needed to protect the City and its taxpayers. Under the adverse domination doctrine, the statute of limitations is tolled until a new City Council, made up of members not adversely dominating the City's government, takes office as the knowledge giving rise to the City's cause of actions to set aside the unlawful debt cannot be imputed to the City.

XII.
CONCLUSION

The City is currently facing a funding debt in excess of $2 billion in its pension system as a result of a number of governmental decisions including, but not limited to, the creation of illegal retirement benefits. The City Council and the Mayor need to take action now to reverse the creation of this illegal public debt so that all citizens of the City of San Diego can benefit from funds that would now be available for public services. However, the people who participated in creation of this illegal debt remain on the City Council. If these persons do not take the actions necessary to benefit the public at large, but rather, continue to thwart all attempts to undue the creation of the illegal debt, then these persons adversely dominate the City Council, and the right of the citizens of the City of San Diego to legally redress this wrong is stayed until these persons leave office.

By _____
Michael Aguirre
San Diego City Attorney

EXHIBIT 48

ATTORNEY TO CLIENT CORRESPONDENCE

FOR CONFIDENTIAL USE ONLY

Office of
The City Attorney
City of San Diego

MEMORANDUM

236-6220

DATE: November 19, 2001

TO: Honorable Mayor and City Council Members

FROM: Leslie J. Girard, Assistant City Attorney

SUBJECT: Letter from Bruce Henderson (September 20, 2001) Regarding Ballpark Project

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A number of Council members have requested copies of the letter from Bruce Henderson to the City Attorney, dated September 20, 2001, setting forth Mr. Henderson's claims about proceeding with the issuance of bonds for the Ballpark Project at this time. Enclosed, please find a copy of the letter for your review. Please call if you have any questions.

CASEY GWINN, City Attorney

By
Leslie J. Girard
Assistant City Attorney

Enclosure

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PRESS RELEASE -- FOR IMMEDIATE RELEASE
21 SEPTEMBER, 2001

10 PAGES, INCLUDING THIS COVER SHEET

SAN DIEGO -- STATEMENT BY SDTF CHAIR RICHARD RIDER:

AFTER REVIEWING BRUCE HENDERSON'S LETTER (ENCLOSED) TO CITY ATTORNEY CASEY GWINN DEMANDING A PUBLIC VOTE ON CHANGES TO THE BALLPARK MOU, I FELT THIS PIECE SHOULD BE DISTRIBUTED TO THE MEDIA. THE LETTER DOES AN EXCELLENT JOB SUMMARIZING THE REASONS WHY THIS BALLPARK MESS SHOULD BE BROUGHT BEFORE THE VOTERS FOR A VOTE TO VALIDATE ALL THE CHANGES TO THE MOU THAT HAVE BEEN MADE.

IT IS HOPED THAT THE NEW SAN DIEGO CITY MAYOR AND CITY COUNCIL WILL RECOGNIZE THAT NOW IS THE TIME TO REASSESS THE ECONOMIC AND LEGAL RAMIFICATIONS OF GOING FORWARD WITH THIS ILL-ADVISED PROJECT. ASSUMING THAT THEY LACK THE COURAGE TO KILL THE PROJECT THEMSELVES (GIVEN THAT THE MOU IS NO LONGER VALID), THE LEAST THAT THEY CAN DO IS PUT THE NEW MOU AND ITS AMENDMENTS ON THE MARCH, 2002 BALLOT FOR A VOTE BY THE PEOPLE OF SAN DIEGO.

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September 20, 2001

Casey Gwinn
San Diego City Attorney
Civic Center Plaza
1200 Third Avenue, Suite 1600
San Diego, CA 92101

Re: Requirement Of Public Vote To Approve MOU Amendments

Dear Mr. Gwinn:

Almost three years have passed since San Diego voters on November 3, 1998, approved Proposition C ("Prop C") and its Memorandum of Understanding ("MOU") between the City and its Redevelopment Agency and the San Diego Padres.

The Prop C and the MOU set out the terms of a project designed to funnel an unprecedented amount of City revenues (the "Padres' subsidies") over the next thirty to forty years into the construction and operation of a downtown ballpark as well as other retail and commercial projects, all for the benefit of the San Diego Padres and those lucky few with whom the owners of the Padres might eventually agree to share their windfall.

The time has now come to put the Padres' subsidies back before the voters. The most reasonable date for this vote would be March 5, 2002, a date on which there is already a regularly scheduled city-wide election.

Naturally, proponents of the Padres' subsidies fear a new vote, are irritated when taxpayer advocates label the Padres' subsidies as corporate welfare, and even go so far as to blame "delays" on urban terrorism.

Contrary to the claims of those who support the Padres' subsidies, the culprits responsible for all the problems in implementing the MOU over the last three years, are not the opponents. Rather, to identify these culprits, the proponents merely need to look into any mirror.

Obviously, opponents of the Padres' subsidies are not to blame for the unprecedented criminal activity of former Councilwoman Valerie Stallings.

Similarly, opponents are not to blame for the decision of the City to delay environmental review until after the Prop C vote – a decision now unambiguously illegal in California.

Nor are opponents to blame for the unrealistic economic assumptions that have plagued each and every element of this proposal. In 1998 and again in 1999, the Padres told us we could rely on their commitment to construct 1,850 new hotel rooms, vast new retail space, and highrise offices. None of these projects made economic sense in 1998, and the only effect of the passage of the last three years has been to demonstrate more and more clearly that the demand for these developments does not exist.

San Diegans were also promised prior to the Prop C vote in 1998 that the San Diego Unified Port District (the "Port") would toss in $21 million from excess revenues it was enjoying. Well, three years later that money still hasn't been paid, and there is little reason to believe that it ever will be paid since the transaction relies, without going into the details, on the literal transformation of land to be acquired by the City at fair market value at highest and best use for approximately $14 million *instantaneously* into land with a fair market value for surface parking of $42 million – a miraculous transformation beyond even the wildest imaginings of practitioners of medieval alchemy.

Naturally, that $42 million is not the product of an arms-length sale, rather it is the product of a written agreement between the Port and the City stating that the $14 million in land acquired by the City has a value immediately following the acquisition of $21 million to the City and $21 million to the Port. This understanding is required because the Port can't by law make a gift of the $21 million to the City. So, at such time as the Port pays the promised $21 million to the City, the Port has to receive back $21 million in value. Yet, the City, under the terms of the MOU, has to retain on behalf of the ballpark project a contribution from the Port valued at $21 million.

If the economic miracle of transforming land worth $14 million into land worth $42 million doesn't make sense on the first reading, don't bother rereading the explanation. A second effort won't help because the transaction never made sense from the beginning.

Even more important than the issue of the Port's $21 million contribution, the City conditioned the Padres' subsidies on the promise to taxpayers that tax revenues from the various developments would fund expenditures by the City and its Redevelopment

Agency. And, the City also promised that all these expenditures would be capped. Yet, consider the MOU's cap of $50 million on expenditures by the Redevelopment Agency (and its operating arm, CCDC). That "cap" was long ago surpassed so that to date Redevelopment Agency expenditures are approaching $100 million, with no upper limit in sight. Worse, tourist taxes ("TOT") and tax increment that were to be generated by the proposed Padres' projects are nowhere in sight and so, we gather from Councilman Wear's remarks (quoted below), no longer planned as the source for payment of the City's $225,000,000 in bond debt service.

Now, the day of reckoning is at hand; for soon (perhaps by the week of October 8) the City will be compelled by federal law to finally make public a number of important documents and in those documents to specifically confront material facts that presently affect the fundamental decision accorded to the City Council under Prop C prior to the issuance of the $225,000,000 in bond debt. In this process of confronting reality, the City Council will find that it has no alternative but to put the financing decision back on the ballot for a decision by the voters.

First, the City will finally have to provide the public with the proposed amendments to the MOU reflecting the project's changed financing and revenue assumptions. These new proposals have been under discussion since last February. Of course, past practice suggests that the City and Padres will be less than forthcoming in these documents. Fortunately, there are litmus tests that will help us determine the level of candor. For example, will the Padres have available for public review construction bonds or letters of credit guaranteeing the financing and timely construction of all the projects which are requisites to the City's issuance of $225,000,000 in bond debt?

Second, the City will be required to make public the Preliminary Official Statement setting forth as required by federal law the "material facts" affecting repayment of the City's proposed $225,000,000 in bond debt as well as payment of the interest costs over the 30-year life of the bonds.

Third, the City Council will have to now confront two of the most important provisions of Prop C and the MOU. One is Section 33A of the MOU, which provides that the City Council need not proceed with issuing the bonds in the event that the City is unable "to obtain financing for the Ballpark Project on terms reasonably acceptable to the City."

The other provision of the MOU that the City Council will have to confront is Section 38 of the MOU, which among other provisions specifically mandates that any amendments to the MOU that result in a "decrease in revenue to the City" require voter approval.

We've now reached the crux of the upcoming problem for the City and the Padres the week of October 8 and the *real* reason that three years have passed without issuance

of the City's $225,000,000 in bonds. *The City next month has no choice but to acknowledge that the economic premises on which Prop C was based have no reality and that the revenues that implementation of the MOU promised to produce aren't going to be there.*

A harbinger of this painful confrontation with reality were the remarks of Councilman Wear during the September 17th Council meeting. He put it this way, "*A lot has changed since 1998. .... Under the leadership of our mayor, we did come up with an alternative financing package that relies upon tax increment and not TOT.*"

In short, Mr. Wear admits a reality already well known to the City and the Redevelopment Agency – many of us suspect well known since the commencement of this project in 1997, but generally unknown to the public until now: the long-promised TOT to pay for this project isn't going to be there.

Additionally, Mr. Wear suggested in additional remarks on September 17 that even the tax increment revenues required by the MOU would fall short and that the City and Redevelopment Agency would rely, instead of on tax increment revenues from development called for in the MOU, on tax increment revenues from housing being constructed in various areas downtown under the jurisdiction of the Redevelopment Agency.

What was not clear to us from Mr. Wear's remarks or from the remarks of other officials who commented at the September 17 meeting of the Council is whether these substantive reductions in revenues to the City will be reduced to writing and adopted as written amendments to the MOU. The requirement for written amendments is clearly stated in Section 38 of the MOU.

As we have stated, while we have no doubt that you are quite aware that these matters must be disclosed in the Preliminary Official Statement, it is not so clear that you have so far exhibited an understanding that these alterations to the obligations of the Padres require written amendments to the MOU and, as well, trigger the requirement of voter adoption since they "decrease revenue to the City" as that term is used in Section 38 of the MOU.

In this connection, as you may or may not recall, the ballot question for Prop C was unambiguous in *conditioning* voter approval of Prop C on the understanding that the costs of the project to the City would be paid from TOT revenues generated by hotel rooms specified in the MOU and from redevelopment funds. The ballot question for Prop C read as follows:

> Shall an ordinance be adopted authorizing the City of San Diego to enter into agreements to redevelop an area of downtown, and construct a multiple use ballpark, **provided that**: 1) the City's

> participation requires no new taxes, is capped, and also **limited to** redevelopment funds and **an amount equivalent to certain hotel tax revenue**; and 2) the San Diego Padres guarantee substantial private contributions, pay all ballpark construction cost overruns, and play in San Diego until 2024? [emphasis added]

The "certain hotel tax revenue" referred to in the ballot question was, according to the MOU, to flow from several hotel developments which by the terms of the MOU were to be constructed in a timely manner as a condition of the City providing project funding. This elemental aspect of the bargain was confirmed in a resolution adopted March 31, 1999, by both the City and the Redevelopment Agency, which resolution reads in pertinent part as follows:

> 6. ... the Padres have made a written commitment to construct a 500 room ballpark hotel, 200 room suite type hotel, and a 150 room boutique hotel, all within the Ballpark District and consistent with the program set forth in the MOU, and ... this program is designed to have the ability to generate annualized TOT revenue sufficient to help support the City investment in the project.
>
> 9. ... a 1,000 room convention center expansion hotel will proceed and has the potential to generate the required new public revenue to help finance the city and agency investments in the ballpark and redevelopment project, ... [based] upon the commitment of John Moores, expressed in his letters to the Port District and City, to have JMI Realty cause the development of an expansion hotel; and upon the term sheet regarding an expansion hotel agreed upon by the Port District, City and JMI Realty.

This March 31, 1999, resolution sets out the details from Prop C reflected in the ballot question. That is, the "certain hotel tax revenue" upon which voter approval of Prop C was conditioned would flow from the construction of the 1,850 hotel rooms specified in the March 31 resolution.

Unfortunately, but not surprisingly, Mr. Wear's remarks evidence the current reality that John Moores, the Padres, and JMI Realty have terminated any commitment they might have undertaken in the past to "cause the development of an expansion hotel." In short, the ballpark project is not going to produce anything close to 1,850 hotel rooms; and the City's TOT revenue from the ballpark project construction will decrease accordingly. In fact, as of the date this letter is written, it is not known if *any* hotel rooms will be constructed pursuant to the terms of the MOU.

It follows, therefore, that these new realities must not only be disclosed in the Preliminary Official Statement, but also must be set forth in written amendments to the

MOU which amendments require voter approval for adoption. In this regard Section 38 of the MOU reads:

> XXXVIII. Modifications To MOU.
>
> Except as specifically set forth in this MOU, this MOU may not be modified or amended without the affirmative vote of a majority of the electorate of the City voting at an election held for that purpose.
>
> The City Council may agree to amend or modify this MOU without a vote of the electorate only if such amendments or modifications do not materially: 1) decrease the rights or increase the obligations of the City; 2) increase the financial commitments of the City; or 3) decrease revenue to the City.
>
> Any modifications or amendments to this MOU must be in writing and signed by all the Parties.

We understand that the City and Redevelopment Agency review of the Preliminary Official Statement and the alternations to the MOU is tentatively scheduled for October 9, 2001. As we read the MOU, this review initially presents two issues. First, do the new financing realities decrease revenue to the City and so trigger Section 38's requirement of a vote of the electorate? Second, is the proposed financing acceptable, were the voters to approve the decreased revenue?

At that same meeting, a number of additional concerns must be addressed involving material facts that must be disclosed in the Preliminary Official Statement and which may by themselves also trigger Section 38's requirement of a public vote. Among these concerns is the status of several of the additional sources of revenue or capital contributions required by Prop C and the MOU.

Again, referring back to the March 31, 1999, resolution of the City Council and the Redevelopment Agency, a key paragraph reads:

> 5. ... the Padres have made a written commitment to construct **private development** that is designed to produce an assessed value of **at least $289 million**, which amount has been confirmed by CCDC as sufficient to finance the Redevelopment Agency investment in the project. [emphasis added]

This "private development" is described in Section 31 of the MOU. This "private development" is separate from and in addition to the hotel rooms previously mentioned. The "private development" includes office complexes containing at least 600,000 gross square feet with associated parking; retail development containing at least 150,000 gross

square feet; and approximately 2,238 parking stalls. Certificates of occupancy (which trigger the commencement of property taxes on the new construction) for the office complexes and the retail space are required under the terms of Section 31 of the MOU to be obtained no later than January 31, 2002 – *some four months from now.*

The MOU's guarantee of construction of hotel rooms, office complexes, retail, and parking has been acknowledged again and again as a critical component of the City and Redevelopment Agency's decision to proceed with a $225,000,000 bond issuance. For example, on March 31, 1999, the City and Redevelopment Agency resolution provided in relevant part:

> 13. ... the actions or agreements of the parties on or before April 1, 1999, do not in any way alter, amend, waive or otherwise affect the conditions subsequent set forth in section 33 of the MOU. In particular, ... the terms of any City or Agency financing, whether interim or permanent, must be reasonably acceptable to the City, which terms include, but are not limited to, the sources of revenue to pay for the financing; the status of Phase 1, any Substitute Ancillary Development and the expansion hotel; and any other matter which may affect the City's financing not only of the ballpark and redevelopment project, but of any other current or future city project.

Another example of the City Council's acknowledgement of the critical importance of the hotels, office complexes and retail guaranteed by the MOU to be constructed by the Padres to produce tax revenues necessary for the City to pay the interest and principal on the $225,000,000 of City bond debt is found in the minutes of the City Council for its meeting of February 6, 2001:

> Consistent with Section XXXIII.A of the MOU, the City Council reaffirms and reserves to the City the right to determine that the terms of any City or Agency funding or financing, whether interim or permanent, must be reasonably acceptable to the City, which terms include, but are not limited to, that status of sources of revenue to pay for the funding or financing (**including but not limited to hotel rooms, transient occupancy taxes and the investment from the Unified Port District**), and any other matter which may affect the City's financing not only of the Project but of any other current or future City project. [emphasis added]

Note the reference to the Port's $21 million investment, which reflects yet another financial contingency that remains to be met before the City Council can approve a bond issuance. Section 19 of the MOU makes this point quite clearly:

XIX. Other Required Financing Investments.

> The City and the Padres will cooperatively endeavor to obtain from other public and quasi-public sources commitments to provide funds or financing for land, parking, transportation, Infrastructure improvements, or other value reasonably acceptable to the Parties, sufficient to provide the **$21 million in added value** needed to reach the Ballpark Project Estimate of $411 million. [emphasis added]

We have no idea what the status of this $21 million investment will be on October 9, 2001; however, at present this $21 million is not available and there are a number of good reasons to believe that it never will be available to the ballpark project, at least from the Port.

A problem that had to be faced in preparing this letter is that the proposed revisions to the MOU and the proposed Preliminary Official Statement in connection with the $225,000,000 bond issuance have yet to be made public. Consequently, the comments in this letter are necessary general in nature.

Nevertheless, given Mr. Wear's remarks and given what is now known to the public, it appears to us that the MOU must be amended to acknowledge the extraordinary reduction in revenues to the City that result from the decisions of the parties to the MOU to relieve the Padres from the MOU's requirements for much of the hotel, office and retail construction originally mandated by Prop C and the MOU.

Of course, we note again, that these MOU amendments cannot take effect without voter approval. And, as mentioned previously, this matter can be readily placed before the voters at the currently scheduled citywide election March 5, 2002.

This letter precedes an additional communication we are preparing to be sent to the Securities and Exchange Commission (the "SEC"). Since the City has not made public, at least to our knowledge, a draft of the Preliminary Official Statement, we are attempting to identify material facts that we fear from past experience may be omitted or misstated in that document.

—7 To anticipate the letter to the SEC in one respect, we note that several legal cases headed up to the appellate courts raise the issue of whether the MOU is void due to the criminal activities of former Councilwoman Stallings.

If the MOU is ultimately determined by the courts to be void, will it follow that authority to make subsequent principal and interest bond payments would require voter approval pursuant to the terms of City Charter Section 90.3? In that event, what would the impact on bondholders be of voter rejection of a resubmitted MOU? Would bondholders be limited to taking title to the ballpark, subject to the annual rent of

$500,000 from the Padres? If so, could bondholders reasonably be expected to recover any substantial portion of the principal and interest otherwise payable? Or, would the City be required to pay the principal and interest even if the MOU is void due to criminal acts?

These questions and many other issues appear to us to be material matters that both citizens of San Diego and potential holders of the proposed debt should consider prior to any financial commitment.

In all of this there is good news, for each and every one of the problems with this project could be resolved with one simple step, namely, a fully informed public vote taking into account the environmental impacts as well as the economic realities of this exercise in corporate welfare – the very vote that we have long advocated.

Sincerely,

/s/

J. Bruce Henderson

(Corrected)